IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

MARK NEWBY, et al.,	§	
	§	
Plaintiffs,	§	
	§	
	§	CIVIL ACTION NO: H-01-3624
v.	§	AND CONSOLIDATED CASES
	§	
ENRON CORPORATION, et al.,	§	
	§	
Defendants.	§	
	§	
PAMELA M. TITTLE, on behalf of herself and a class of persons similarly situated, et al.,	§	
	§	
Plaintiffs,	§	
	§	
	§	CIVIL ACTION NO: H-01-3913
v.	§	AND CONSOLIDATED CASES
	§	
ENRON CORP., an Oregon Corporation, et al.,	§	
	§	
Defendants.	§	

CERTAIN DEFENDANTS' JOINT
BRIEF RELATING TO ENRON'S DISCLOSURES

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**CERTAIN DEFENDANTS' JOINT
BRIEF RELATING TO ENRON'S DISCLOSURES**

TO THE HONORABLE MELINDA HARMON:

I. INTRODUCTION

Plaintiffs have sued more than eighty Defendants in connection with the collapse of Enron. Some of these Defendants worked at Enron, some at Arthur Andersen, some at law firms and some at various investment firms. Nevertheless, in more than 800 pages of allegations, the *Newby* and *Tittle* Plaintiffs contend that each of the eighty Defendants is responsible for Enron's collapse and for the alleged "concealment" of the "facts" that led to Enron's demise. Plaintiffs' concealment claims ignore what Enron actually disclosed.

Plaintiffs bear the burden first to plead and then to prove that Enron and these eighty Defendants engaged in wrongful conduct. Yet Plaintiffs only rarely cite an actual disclosure document filed by Enron. They cite analyst reports, press clippings, rumor and innuendo, but almost never point to a single statement or omission by Enron (much less by any Defendant) that they allege was actually misleading when made. Instead, Plaintiffs substitute fiction for fact, group pleading for specific allegations, and rhetoric for reason —all in an effort to shift to the Court and the Defendants the burden to excavate their massive complaints to see whether there is a needle in this 800-page haystack that supports Plaintiffs' claims of fraud.

Neither Rule 8, nor Rule 9(b), permits this approach. The courts repeatedly have condemned the "puzzle pleading" approach taken by the Plaintiffs in this case, and have dismissed complaints like these because they are not "short, plain statements" of the claim, Fed. R. Civ. P. 8, and instead use a garrulous style to "mask an absence of detail." *Williams v. WMX*

Technologies, Inc., 112 F.3d 175, 178 (5th Cir. 1997); *see also Wenger v. Lumisys, Inc.*, 2 F.Supp.2d 1231 (N.D. Cal. 1998).

The Defendants view Plaintiffs' broad brush approach as an opportunity to set out for the Court, with particularity, what Enron actually disclosed about its business and its accounting practices. This is important in a case that has witnessed a firestorm of publicity—much of it misguided—that has accepted the assumption that Enron was nothing but a massive fraud. Plaintiffs' Complaints, in fact, rest on that premise and then proceed to attack literally every business line, and nearly every business decision, Enron made over the last three years.

What has been lost in this storm are the facts. Enron, before it collapsed, was a respected public company—one of the ten largest in America. It was a great innovator, a believer in deregulation, a company willing to take risks (and willing to manage those risks) in order to maximize value for its shareholders. Enron was advised by the most eminent professional firms in America. Its Board of Directors was rated, routinely, as among the best in the nation. It included people of unquestioned integrity, possessed of enormous skill and expertise. Enron's senior management had no incentive to see the company in which they had invested so much fail. It strains credulity to suggest that people and firms such as these were engaged in a conscious scheme to defraud the public for years concerning the nature of Enron's business and its financial condition.

When the Court reviews Enron's disclosures under applicable Fifth Circuit precedent it becomes clear that there was no such scheme. Enron's disclosures were adequate, complete and disclosed the facts Plaintiffs contend were concealed or misrepresented. In order to illustrate this point, the Defendants have extracted from the morass of Plaintiffs' allegations each of the alleged misstatements and omissions. The Defendants have then sorted those allegations into organized sections (*e.g.*, accounting issues, Enron's restatement, related party transactions, retail energy, wholesale energy, broadband and international operations) and placed them in the context of Enron's actual disclosures and the facts known to the market, as evidenced by documents Plaintiffs rely upon in their Complaints.

The result of this effort is a lengthy and comprehensive demonstration of the adequacy of Enron's disclosures which stands in sharp contrast to the emptiness of Plaintiffs' pleadings—particularly when one considers the enormous "pretrial discovery" that has been available to assist Plaintiffs in drafting their Complaints.[1] Defendants have uncovered what Plaintiffs sought

[1]Plaintiffs have had access to the following resources to assist them in drafting their Complaints:

1. Enron's Board commissioned an independent investigation of its related party transactions. The report of that investigation, the so-called Powers Report, was published more than two months before Plaintiffs' Amended Complaints were filed;
2. There have been more than ten Congressional hearings, in which many witnesses have testified under oath. The transcripts of that testimony are available publicly on various Congressional websites and through various subscription services;
3. Documents from Arthur Andersen and Enron have been produced to, and made public by, various Congressional committees;
4. Enron, and the circumstances that led to its demise, have been the subject of front-page news coverage in the major financial press and in the nation's leading newspapers for the six months preceding the filing of Plaintiffs' Complaints; and
5. Enron has laid off thousands of employees, many of whom Plaintiffs' counsel are interviewing as the source of "inside" information concerning the company's affairs. *See e.g.* Affidavit of Paul Howes, filed in support of Application for Temporary Restraining Order against Arthur Andersen.

to hide through their convoluted pleadings; namely, that Enron disclosed the transactions and the adverse events that affected them, that the company provided meaningful cautionary language to advise the public of the specific risks associated with its projects, and that the *Newby* and *Tittle* Complaints are devoid of particularized facts illustrating that any individual Defendant knew, at the time Enron made these disclosures, that there were material facts about Enron that were being misstated or were not disclosed to the public.

The pleading rules that apply to this case are clear and should not be ignored because this case involves Enron, rather than a less well-known company. When those rules are applied, in the context of the disclosures Enron made, it is apparent that Plaintiffs have stated no claim for relief. Accordingly, for the reasons stated in this brief, and those stated in the separate briefs that address Plaintiffs' failure to plead fraud with particularity, the Defendants[2] submit that Plaintiffs' Complaints must be dismissed.

In fact, so profound has been the pretrial "discovery" on these matters that it is now possible to log onto Westlaw or Lexis and click into the "Enron" database to find, assembled in one place, a mass of documents, news articles and analysis relating to the collapse of the company. Plaintiffs have had ample opportunity to plead with particularity the facts they contend illustrated Enron's non-disclosure.

[2]This Joint Brief Relating to Enron's Disclosures is joined by: Richard Buy, James V. Derrick, Mark A. Frevert, Kevin Hannon, Joseph M. Hirko, Stanley C. Horton, Steven J., Kean, Mark E. Koenig, Michael S. McConnell, Jeffrey McMahon, Cindy K. Olson, Kenneth D. Rice, Joseph Sutton and Lawrence G. Walley. It is also joined by the Estate of Clifford Baxter and Mark Metts who are only named as Defendants in *Tittle.*

II. PLAINTIFFS' ALLEGATIONS OF ACCOUNTING VIOLATIONS FAIL TO STATE A CLAIM FOR FRAUD.

Plaintiffs allege that Enron violated Generally Accepted Accounting Principles ("GAAP") and principles of fair presentation of its financial results by using secret partnerships and special-purpose entities to "inflate its profits and hide its debt." *See, e.g.*, NCC at ¶ 4; TCC at ¶ 826. Plaintiffs repeat variations of these conclusory statements throughout the two Complaints' 800-plus pages.

As detailed below, Enron disclosed the obligations that Plaintiffs contend were "hidden." Enron's 2000 Annual Report alone shows that Enron disclosed over $66 billion in liabilities, including debt and contingent exposures both on and off the balance sheet. Plaintiffs do not mention, much less analyze, these and other disclosures. Their allegations fail under the plain requirements of Rule 8, Rule 9(b), and the PSLRA.

A. THE ORGANIZATION AND STRUCTURE OF PLAINTIFFS' COMPLAINTS HAVE PREVIOUSLY BEEN HELD TO VIOLATE RULE 8.

In both Complaints, Plaintiffs provide hundreds of pages of myriad quotes from different sources, and then make a sweeping statement that all such statements are "false" and evidence "accounting fraud." They then refer the Court and the individual Defendants to a laundry list of summary "true but concealed facts" for the reader to piece together like a puzzle. The same structure has been held to be a "mockery" of the PSLRA and a violation of Rule 8. *Wenger,* 2 F. Supp. 2d at 1243-44.

The same pattern holds for Plaintiffs' accounting allegations. Plaintiffs fail to allege, or provide specific facts to support, that any individual Defendant was aware of an alleged violation of GAAP. Plaintiffs rarely cite any specific GAAP principles, and when they do, the provisions are often inapplicable. The puzzle-like nature of the Complaints violates Rule 8, particularly where the pieces of that puzzle provide little or no clue of the specific basis for alleged accounting fraud.

B. PLAINTIFFS' FAIL TO PROPERLY PLEAD A GAAP VIOLATION, LET ALONE SPECIFIC FACTS THAT WOULD SUPPORT A STRONG INFERENCE OF SCIENTER AGAINST THE INDIVIDUAL DEFENDANTS IN CONNECTION WITH ANY SUCH VIOLATIONS.

Enron followed GAAP in the preparation of its financial statements, using the expertise of the nation's top experts in that field. GAAP consists in part of: i) accounting pronouncements of the Financial Accounting Standards Board ("FASB"), the Accounting Principles Board ("APB"), and the American Institute of Certified Public Accountants ("AICPA");[3] ii) opinions of the Emerging Issues Task Force ("EITF"); iii) guidelines from the Securities Exchange Commission ("SEC"), including staff accounting bulletins ("SAB") and even less formal communications. In the event there is no official pronouncement, the consensus of the accounting profession, for instance in textbooks, becomes GAAP. *Providence Hosp. of Toppenpish v. Shalala*, 52 F.3d 213, 218 n. 7 (9th Cir. 1995) (quoted with approval *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446, 1457 (N.D. Cal. 1996)). Which of these principles or components Plaintiffs claim were violated is part of the puzzle the Plaintiffs leave to the Court's and Defendants' speculation.

[3]These pronouncements include, among others, Statements of Financial Accounting Standards ("SFAS"), APB Opinions, and Accounting Research Bulletins ("ARB").

As the Fifth Circuit stated: "The term 'generally accepted accounting principles,' as we have often noted, is a term of art encompassing a wide range of acceptable procedures, such that 'an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures when that accountant prepares a financial statement.'" *Lovelace v. Software Spectrum, Inc.,* 78 F.3d 1015, 1021 (5th Cir. 1996) (quoting *Godchaux v. Conveying Techniques, Inc.,* 846 F.2d 306, 315 (5^{th} Cir. 1988). The APB echoes the Fifth Circuit: "Applying generally accepted accounting principles requires that judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities." APB Op. No. 22.

Taken in the light most favorable to the Plaintiffs, the Complaint alleges that Enron failed to properly apply GAAP and published inaccurate financial information as a result. Those allegations, without more, do not state a claim for securities fraud. Because application of GAAP is more an art than a science, the Fifth Circuit concluded that: "[T]he mere publication of inaccurate accounting figures, *or a failure to follow GAAP*, without more, does not establish scienter. The party must know that it is publishing materially false information, or the party must be severely reckless in publishing such information." *Lovelace,* 78 F.3d at 1020 (from *Fine v. American Solar King Corp.,* 919 F.2d 290, 297 (5^{th} Cir. 1990), *cert. dismissed sub. nom, Hurdman v. Fine,* 502 U.S. 976, 112 S. Ct. 576, (1991)) (emphasis added).[4] The Plaintiffs'

[4]*See also, In re Ikon Office Solutions, Inc. Securities Litigation,* 131 F. Supp. 2d 680, 703 (E.D. Penn. 2001) ("The failure to follow professional standards by itself does not necessarily establish scienter, nor does the use of unreasonable accounting procedures. . . . Rather, the violations must be extraordinarily egregious, permitting an inference of a pretended audit with no genuine belief behind it.") (citations omitted).

failure to plead specific facts indicating that each Defendant consciously published materially false information is also fatal. *Lovelace*, 78 F.3d at 1020 ("we find that Plaintiffs have not alleged specific facts sufficient to indicate that Defendants consciously published materially false information.").[5]

As an adjunct to the Plaintiffs' allegations of GAAP violations, Plaintiffs allege that Enron's financial statements failed to present its financial condition fairly. NCC at ¶¶ 4, 424-30; TCC at ¶¶ 6, 205, 213, 225, 232. They fail, however, to explain which part of each financial statement is allegedly overstated or understated, and why. *Haft v. Eastland Financial Corp.,* 755 F. Supp. 1123, 1129 (D.R.I. 1991) ("When plaintiff contends that 'the [defendant] has not throughout the class period taken all adjustments which were necessary for a fair presentation of the consolidated financial statements,' how should the defendant begin to answer this charge? . . . . Defendant needs more than mere speculation to respond."). Similarly, conclusory allegations that a defendant recklessly disregarded accounting standards regarding the fair presentation of financial position do not satisfy Rule 9(b). *Duncan v. Pencer,* 1996 WL 19043, *11 (S.D.N.Y., Jan. 18, 1996). Plaintiffs also ignore specific disclosures in notes to the financial statements, quoted below, that inform the public of Enron's transactions.

Plaintiffs must specify which parts of financial statements were overstated, which were understated, why they are inaccurate, and how each Defendant knew those facts at the time.

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[5]Even deliberate violations of GAAP or GAAS do not without more amount to fraud. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994). In fact, deviation from accounting standards does not itself even spell negligence. *SEC v. Pricewaterhouse*, 797 F.Supp. 1217, 1241 & n.57 (S.D.N.Y. 1992).

Geinko v. Padda, 2001 WL 1163728, 6 (N.D. Ill. Sept. 28, 2001) (10(b) claim against officer dismissed where the plaintiffs alleged that defendant falsely represented that financial statements fairly presented the company's condition, because plaintiffs did not plead facts showing defendant knew the assets or earnings were mischaracterized). The Plaintiffs fall short of this standard.

C. PLAINTIFFS' ACCOUNTING ALLEGATIONS FAIL THE PLEADING REQUIREMENTS AS TO INDIVIDUAL DEFENDANTS.

Plaintiffs' allegations regarding Enron's financial statements begin in Paragraph 418 of the *Newby* Complaint with the assertion that "the defendants caused the Company to violate GAAP and SEC rules, in several ways . . . ." For the next 223 paragraphs, Plaintiffs' description of various Enron transactions and alleged accounting malfeasance is virtually devoid of the mention of any of the individual Defendants. The handful of references that are made to a few individuals do not:

> allege what actions <u>each</u> Defendant took in furtherance of the alleged scheme and specifically plead <u>what</u> he learned, <u>when</u> he learned it, and <u>how</u> Plaintiffs know what he learned.

In re Securities Litigation, BMC Software, Inc., 183 F. Supp. 2d 860, 886 (S.D. Tex. 2001) (emphasis added).

The general allegation that "defendants caused the Company to violate GAAP and SEC rules" is insufficient to state a claim against the individual Defendants under Rule 8, Rule 9(b), and the PSLRA. Even if Plaintiffs properly pleaded a GAAP or SEC rule violation by Enron -- which they have not -- nowhere do Plaintiffs: (1) list which specific Defendants knew of the alleged violation; (2) what *those* Defendants knew of the violation; (3) when *those* Defendants learned of the information; (4) how *those* Defendants learned of the information, or (5) what *those* Defendants did with the information, if anything, after discovery. Plaintiffs plead no facts detailing which Defendants prepared or were involved in preparing the financial statements, how the information was gathered and verified, who reviewed the financial statements or any other facts that would give rise to an inference that any of the individual Defendants knew of or were involved in a scheme to commit fraud. These pleading deficiencies are fatal under the PSLRA.

III. ENRON'S FINANCIAL STATEMENT DISCLOSURES DID NOT HIDE DEBT OR CONCEAL THE EFFECT OF THE RELATED PARTY TRANSACTIONS.

A. ENRON'S DEBT DISCLOSURES INFORMED INVESTORS OF THE AMOUNT OF ITS CONSOLIDATED AND ITS UNCONSOLIDATED DEBT EXPOSURE.

One of Plaintiffs' persistent conclusory allegations is that Enron "conceal[ed] billions of dollars of debt that should have been shown on Enron's balance sheet." NCC at ¶¶ 121(a), 155(a), 214(a), 300 (a), 399(a), 418(a). But this debt was shown. In its 2000 Annual Report, Enron disclosed, through the text and notes,[6] over $66 billion in liabilities, including debt and other contingent exposures, and $65.5 billion in assets. Similar disclosures are contained in Enron's Financial Statements throughout the alleged Class Period. The liabilities or the information needed to calculate debt was disclosed as follows in the 2000 Annual Report:

Total Current Liabilities, Balance Sheet, p. 33	$ 28,406,000,000
Long-Term Debt, Balance Sheet, p. 33	8,550,000,000
Deferred Credits, Balance Sheet, p. 33	13,759,000,000
Company-Obligated Pref. Sec., Balance Sheet, p. 33	904,000,000
Convertible Senior Notes, n. 7, p. 41	1,900,000,000
Minority Interests, n. 8, ¶3, p. 41-42	500,000,000

[6]Under GAAP such notes constitute an integral part of the financial statements. The reader of the financial statements is told numerous times that the "accompanying notes are an integral part of [the] consolidated financial statements."

Minority Interests, n. 8, ¶4, p. 41-42	500,000,000
Minority Interests, n. 8, ¶5, p.42	750,000,000
Whitewing, n. 10, p. 43	2,428,000,000
Azurix, n. 10, p. 43	1,200,000,000
Equity Instrument Obligations, n. 11, p. 44	3,722,016,000
Other Commitments and Obligations , n. 15, p. 48	4,072,000,000
Total on and off balance sheet debt and exposure	$ 66,691,016,000

SEC App. Tab 16, at 33, 41-44, 48. Plaintiffs do not refer to these disclosures and point to no inadequacy in them. Over $51 billion of the disclosed liability was "on the balance sheet," but even the $15 billion in "off balance sheet" exposure was not hard to calculate. These disclosures were not vague, and they portrayed a fair picture of the financial exposure of Enron as it was known at the time the financial statements were created.

Plaintiffs' Complaints about "hidden debt" fail under Rule 8, Rule 9(b) and the PSLRA for the fundamental reason that Plaintiffs never identify or quantify the allegedly "hidden" debt. They just generally allege it was "billions."[7] For all the reader knows, Plaintiffs may be describing what was disclosed. They plead no facts to suggest that the "billions" are not the same as the on- and off-balance sheet debt and exposure that was disclosed. Plaintiffs' pleading is also deficient because it does not quantify the debt or link it to any specific transaction or alleged "accounting error."

Plaintiffs' accounting complaints should also be dismissed because they have not (1) tailored their pleadings to specific transactions as required by the PSLRA, (2) specified what portions of the financial statements were inaccurate or misleading, (3) stated why they were

[7] *See e.g.*, NCC at ¶¶ 11, 18, 24, 48, 53, 70, 99, 121(a), (c), (d), (i), 393, 433, 646; TCC at ¶¶ 396, 602.

inaccurate or misleading, and (4) stated how the particular defendant knew at the time that they were misleading.

Plaintiffs' complaint is really not even that the debt was "hidden," but that it was not included on the audited balance sheet, although it was disclosed elsewhere in Enron's financial statements. Plaintiffs' premise fails for two reasons. First, debt of off balance sheet items, such as qualifying SPEs and non-majority owned partnerships, is not on the balance sheet because GAAP did not allow, much less require, Enron to consolidate those entities in its financial statements. *See*, SFAS 94, App. Tab 59; APB 18, App. Tab 59. Second, the "billions" in debt that Plaintiffs claim was "hidden" was disclosed in the notes to the financial statements, providing the investors with a full and fair presentation of Enron's financial exposure. Even a detailed allegation that information was not disclosed will not avoid a motion to dismiss, where public filings in fact establish that disclosure was made. *Lovelace*, 78 F.3d at 1019-20.

The allegedly hidden debt that Plaintiffs complain about falls into three categories: (1) unconsolidated SPEs (Chewco, Marlin Trust, Osprey Trust, Firefly, JV-Company); [8] (2) unconsolidated partnerships (LJM1, LJM2, Atlantic Water Trust, Whitewing);[9] and (3) pre-pays (what Plaintiffs describe as "disguised loans").[10]

As to the first two items, Plaintiffs allege:

> In order to maintain favorable credit ratings, *inter alia*, Enron management and its bankers developed a scheme to keep loans, obtained through partnerships and

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[8] *See* NCC at ¶¶ 496-98; TCC at ¶¶ 396-97.

[9] *See* NCC at ¶ 448-95; 497-505

[10] *See* NCC at ¶ 558-574.

> SPEs, off Enron's financial statements and at the same time inappropriately record income from transactions with these SPEs.

NCC at ¶ 429. Independent of the issue of whether any of the challenged partnerships or SPEs should have been consolidated onto Enron's balance sheet, the debt and contingent exposure related to these entities was publicly disclosed in the notes to the financial statements. By way of example, Enron's potential exposure on Azurix/Marlin is disclosed note 10 of the 2000 Annual Report:

> In connection with the 1998 financial restructuring (yielding proceeds of approximately $1.2 billion) of Enron's investment in Azurix, *Enron committed to cause the sale of Enron convertible preferred stock, if certain debt obligations* of the related entity which acquired an interest in Azurix, *are defaulted upon, or in certain events, including, among other things, Enron's credit ratings fall below specified levels. If the sale of the convertible preferred stock is not sufficient to retire such obligations, Enron would be liable for the shortfall.* Such obligations will mature in December 2001. The number of common shares issuable upon conversion is based on future common stock prices.

SEC App. Tab 16, at 43. The note states that "Enron would be liable for the shortfall," if any, of the Azurix/Marlin debt, even if the amount of the debt exceeded the amount of convertible preferred stock pledged to the transaction.

The Whitewing exposure was also disclosed in note 10 of the 2000 Enron Annual Report:

> In 1999, all outstanding shares of series A Preferred Stock held by Whitewing were exchanged for 250,000 shares of Enron Mandatorily Convertible Junior Preferred Stock, Series B (Series B Preferred Stock). Also in 1999, Enron entered into a Share Settlement Agreement under which Enron could be obligated, under certain circumstances, to deliver additional shares of common stock or Series B Preferred Stock to Whitewing for the amount that the market price of the converted Enron common shares is less than $28 per share. In 2000, Enron increased the strike price in the Share Settlement Agreement to $48.55 per share in exchange for an additional capital contribution in Whitewing by third-party investors. The number of shares of Series B Preferred Stock authorized equals the number of shares necessary to satisfy Enron's obligation under the Share Settlement Agreement. Absent certain defaults or other specified events, Enron

> has the option to acquire the third-party investors' interests. If Enron does not acquire the third-party investors' interests before January 2003, or earlier upon certain specified events, Whitewing may liquidate its assets and dissolve. At December 31, 2000, Enron had outstanding 250,000 shares of Series B Preferred Stock with a liquidation value of $1.0 billion. The Series B Preferred Stock pays semi-annual cash dividends at an annual rate of 6.50%. Each share of Series B Preferred stock is mandatorily convertible into 200 shares of Enron common stock on January 15, 2003 or earlier upon the occurrence of certain events.

SEC App. Tab 16, at 43. The disclosure states that the potential Whitewing exposure is 250,000 shares of Mandatorily Convertible Junior Preferred Stock, each of which is mandatorily convertible to 200 shares of Enron stock at $48.55 per share. The potential Whitewing exposure disclosed in the 2000 Annual Report is then calculated as follows:

Series B Preferred	250,000
x Conversion	200
Common Share Equivalent	50,000,000
x Share Settle Strike Price	$48.55
Potential Obligation	$2,427,500,000

Plaintiffs complain, as well, that Enron "concealed" triggers in its financial arrangements that required it to issue additional common stock if the price of Enron stock fell below a certain level. NCC at ¶ 497. This issue is discussed in greater detail in the "related party" section, but the existence of contingent obligations to issue Enron stock was disclosed in a number of places, including, specifically, "Derivative Instruments":

> **Derivative Instruments**
>
> At December 31, 2000, Enron had derivative instruments (excluding amounts disclosed in Note 10) on 54.8 million shares of Enron common stock, of which approximately 12 million shares are with JEDI and 22.5 million are with related parties (see Note 16), at an average price of $67.92 per share on which Enron was a fixed price payor.

SEC App. Tab 16, p. 44. The Equity Instrument Obligation in JEDI and others could be calculated by multiplying the 54.8 million shares by the average share price of $67.92 equaling $3.72 billion in disclosed equity exposure. The method by which Enron accounted for these contingent obligations is disclosed in this section as well. "Shares potentially deliverable to counterparties under the contracts are assumed to be outstanding in calculating diluted earnings per share." *Id.*; *see also* SFAS 128.

These entities were also disclosed in note 9 of the financial statements as unconsolidated equity affiliates. GAAP prohibited the partnerships such as Whitewing and Atlantic Water Trust from being consolidated on the balance sheet because Enron did not have voting control in the partnerships and thus, Enron's interest was accounted for under the equity method of accounting. *See*, APB 18 Tab 59; EITF No. 96-16, App. Tab 64. Similarly, GAAP prevented LJM1 and LJM2 from being consolidated onto the balance sheet because Enron had no financial interest or voting control in either of them. SFAS 94, App. Tab 69; APB 18; EITF No. 96-16, App. Tab 64; EITF No. 97-2 Tab 66.[11]

1. ENRON'S OBLIGATIONS AND EXPOSURE ON MARLIN TRUST AND OSPREY/WHITEWING WERE PUBLICLY DISCLOSED.

In paragraphs 497 to 505, Plaintiffs make a series of specific allegations regarding the Marlin and Osprey Trusts and Whitewing. The allegations include:

> Enron also manipulated its results by treating transfers to assets to a related entity as sales rather than as loans, including energy related projects and dark-fiber broadband. Osprey and Marlin were structured transactions which helped Enron keep debt off its books. NCC at ¶ 497.

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[11]The issue of whether certain of Enron's SPEs and partnerships should have been consolidated is more fully addressed in Section III C. 4 of this Brief.

> Enron promised to issue stock if the partnerships assets of Osprey and Marlin turned out to be worth less than promised. These guarantees were a huge liability, which Enron did not report on its balance sheet. NCC at ¶ 498.

> Enron failed to record charges to reflect the liabilities Enron had incurred and continued to record income from transactions with these entities [even after the value of the transferred assets declined]. NCC at ¶ 500.

Plaintiffs then allege that, under SFAS No. 125 App. Tab 70,[12] GAAP prohibits transferors who maintain continuing involvement in financial assets to record such transfers as sales "unless certain conditions are met." NCC at ¶ 501. Plaintiffs quote SFAS No. 125 and proceed to argue that Enron's transfer of assets of Whitewing should have been accounted for as loans, not sales.

Marlin Trust ("Marlin") is a qualified SPE and Atlantic Water Trust was a related partnership. Atlantic Water Trust, with Marlin and Enron as investors, was formed for the purpose of purchasing Wessex Water. Wessex Water was the initial business that Azurix purchased in the United Kingdom as a platform from which to build a global water business. Marlin was owned by outside investors and Enron did not have a controlling interest or voting control in Marlin or in Atlantic Water Trust. *See generally* SEC App. Tab. 76, at 43. Marlin had debt that was supported by an Enron guarantee as described in note 10 of the 2000 Enron Annual Report. *See* page 13, *supra*.

Osprey also was a qualified SPE. Whitewing was the related partnership. Osprey and Enron were the equity holders in Whitewing, but Enron did not own a controlling interest or have voting control in Whitewing. *See*, SEC App. Tab 16 at 43. Whitewing was formed to

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[12]In September 2000, SFAS 140 (App. Tab 72) superseded SFAS 125. Because most of the transactions referenced by Plaintiffs occurred prior to the adoption of SFAS 140, the Brief references SFAS 125, instead of 140, unless the reference to SFAS 140 is relevant.

invest in energy and other energy related investments, and held $1 billion of convertible preferred stock of Enron. In addition to the necessary equity contribution to establish this SPE, Osprey made other capital contributions to Whitewing through borrowed funds secured with the convertible preferred stock and a put on the same notional number of shares. If there was a credit downgrade of Enron and Enron's stock price dropped below specified levels, Osprey had the right to make Whitewing begin disposing of assets to pay the Osprey debt, beginning with the convertible preferred stock. In that event, Enron was obligated to convert the preferred stock to common stock and sell it. Enron was also obligated to issue and sell more stock if necessary to fully pay the Osprey debt. This is the nature of a share settled put. In short, Enron's obligation and exposure in that regard were disclosed to shareholders in note 10 of Enron's 2000 Annual Report. *See* page 13-14, *supra*.

Plaintiffs never expressly assert that Enron's accounting for Marlin, Osprey and Whitewing was "fraudulent." Plaintiffs appear to assert issues concerning how to account for these transactions. A difference in judgment about generally accepted accounting principles does not establish conscious behavior on the part of Defendants. *Lovelace*, 78 F3d at 1020-21. Plaintiffs never set out the when, what, where, why and how of the involvement and knowledge of each or any Defendant.

It is difficult to decipher the Plaintiffs' claims. For example, even though these deals are set out under a failure-to-consolidate heading, Plaintiffs never expressly state that Whitewing and Atlantic Water Trust should have been consolidated. It is not even clear that Plaintiffs allege that the Marlin and Whitewing exposures were not disclosed – Plaintiffs instead seem to claim that the "items" *should* have been on the balance sheet. But, Plaintiffs fail to specify whether the items refer to Osprey and Marlin or to the guarantees referenced in NCC ¶ 498. The guarantees were contingent exposures that were disclosed in the notes to the financials.

Plaintiffs' claim that transfers of assets to Atlantic Water Trust and Whitewing should have been recorded as secured loans rather than sales under SFAS 125 misapplies the principle. SFAS 125 (now 140) applies only to financial assets, not physical assets. As such, SFAS 125 did not apply to any transaction between Enron and Atlantic Water Trust and only applied to a few transactions with Whitewing. On the few Whitewing transactions where SFAS 125 applied, SFAS 125 provides that transfers of assets can be classified as sales, even when the transferor has continuing involvement with the assets, provided certain conditions are met. To determine whether those conditions are met requires interpretation of the applicable accounting principles to facts and particular situations. Accordingly, they involve the exercise of professional judgment about which reasonable accountants may differ. Plaintiffs acknowledge Enron obtained legal opinions on the control and the bankruptcy remote issues. NCC at ¶ 101. Enron also received extensive advice from Arthur Andersen regarding, in Plaintiffs' words, "every facet" of its business. NCC at ¶ 897. Plaintiffs draw their own conclusions as to how the test should be applied and the results of application, but nowhere do Plaintiffs allege that their conclusion is the only permissible conclusion pursuant to prudent accounting practices. Such differences of accounting judgment do not constitute fraud. *Lovelace,* 78 F.3d at 1020-21.

Finally, even if Enron's accounting treatment somehow violated inapplicable SFAS 125, Enron never hid the fact of the Atlantic Water Trust and Whitewing sales or its accounting treatment of those transfers. In note 9 of Enron's 2000 Annual Report, the fact of the sales was disclosed as was the fact that Enron recorded no gain or loss from the sale:

> In 2000 and 1999, Enron sold approximately $632 million and $192 million, respectively, of merchant investments and other assets to Whitewing. Enron recognized no gains or losses in connection with these transactions. Additionally, in 2000, ECT Merchant Investments Corp., a wholly-owned Enron subsidiary, contributed two pools of merchant investments to a limited partnership that is a subsidiary of Enron. Subsequent to the contributions, the partnership issued partnership interests representing 100% of the beneficial, economic interests in the two asset pools, and such interests were sold for a total of $545 million to a limited liability company that is a subsidiary of Whitewing. See Note 3.

SEC App. Tab 16, at 42 (emphasis added). Then in note 3 of the 2000 Enron Annual Report, Enron disclosed other sales that it made to Whitewing:

> *Securitizations*. From time to time, Enron sells interests in certain of its financial assets. Some of these sales are completed in securitizations, in which Enron concurrently enters into swaps associated with the underlying assets which limits the risks assumed by the purchaser. Such swaps are adjusted to fair value using quoted market prices, if available, or estimated fair value based on management's best estimate of the present value of future cash flow. These swaps are included in Price Risk Management activities above as equity investments. *During 2000, gains from sales representing securitizations were $381 million and proceeds were $2,379 million ($545 million of the proceeds related to sales to Whitewing Associates, L.P. (Whitewing)).*

SEC App. Tab 16, at 38 (emphasis added). Note 3 disclosed that no gains were generated from any sale to Whitewing due to Enron's application of mark-to-market accounting. Instead, the cash received at the transfer was cash proceeds but did not result in gain recognition. The only gain or loss that Enron reported on these entities was that related to its equity interest in the partnership, and those gains and losses would have been reported whether or not the questioned SPEs were consolidated. These citations demonstrate that there was no concealment of these transactions. To the contrary, both the accounting treatment and the transactions were disclosed.

2. OTHER FINANCING STRUCTURES ATTACKED BY PLAINTIFFS WERE ALSO FULLY DISCLOSED.

NCC at ¶ 496 of the *Newby* Complaint states as follows:

Enron also concealed, with the help of its lawyers and the banking defendants, billions of dollars more in debt by using other SPEs.

(a) **Firefly**. Firefly was used in 98 and 99 to acquire the Elektro utility in Brazil. *See ¶¶605-606.* JP Morgan had loaned approximately $1.25 billion to Enron for this purchase. This debt would have hurt Enron's credit rating, so Enron worked discreetly with CS First Boston to structure the Firefly SPE, by which Enron moved $435 million in debt off its balance sheet.

(b) **JV-Company.** JV Co. was an SPE formed to monetize a 4thQ99 energy service outsourcing transaction with Owens-Illinois. JV Co. became the service provider and Enron (EES) became the guarantor. Enron was then able to recognize $10.3 million in 4thQ earnings from the transaction and move $24 million in capital expenditures off of its books.

NCC at ¶ 496 (emphasis in original).

Plaintiffs do not plead an accounting error regarding either Firefly or JV-Company, nor do Plaintiffs allege that anything related to Firefly and JV-Company was fraudulent. Both Firefly and JV-Company were qualifying SPEs under EITF No. 90-15. Firefly was actually created <u>after</u> the acquisition of Elektro in order to purchase a minority interest in Elektro. As such, the "debt" related to Elektro never left Enron's balance sheet. Instead, a portion of it was recharacterized from long-term debt to a minority interest obligation on the balance sheet to reflect Firefly's purchase of the minority interest. The debt and earnings associated with the SPEs themselves were properly not a part of Enron's financial statements. Plaintiffs do not allege that Firefly and JV-Company fail the SPE tests nor plead details that would support any such claim.

B. PLAINTIFFS' ALLEGATIONS ABOUT HEDGING DO NOT STATE A CLAIM FOR FRAUD.

1. ENRON DISCLOSED ITS HEDGING ACTIVITY.

Plaintiffs allege that Enron hedged its investments, and that the hedging was either "phony or illusory," or that Defendants were motivated to create illusory hedges.[13] NCC at ¶¶ 34, 121(e), 155(e), 214(e), 300(e); *see also* NCC at ¶¶ 155(1), 214(n), 300(p) ("illusory not real"). Again, however, Plaintiffs avoid directing the Court to Enron's actual disclosures on this issue. Enron's related party disclosure informed the public of Enron's use of hedges and "price risk management activities."

Enron discusses its hedging activities in a number of sections of its Forms 10-K. In these sections, Enron explained how it used hedges, what sorts of hedges it used (including <u>low-correlation hedges</u>), what changes in asset value those hedges were intended to offset and, how the revenue from those hedges was reflected in Enron's financial statements. For example, in its section on Wholesale Services, Enron explained how it used hedges to minimize risk and maximize value:

> Wholesale Services manages its portfolio of contracts and assets in order to maximize value, minimize the associated risks and provide overall liquidity. In doing so, Wholesale Services uses portfolio and risk management disciplines, <u>including offsetting or hedging transactions</u>, to manage exposures to market price movements (commodities, interest rates, foreign currencies and equities). Additionally, *Wholesale Services manages its liquidity and exposure to third-party credit risk through monetization of its contract portfolio or third-party insurance contracts*. Wholesale Services also sells interests in certain investments and other assets to improve liquidity and overall return, the timing of which <u>is</u>

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[13]Further discussions regarding Enron's hedging transactions, including those with the Raptors, is discussed *infra*, Section III.B.2.

dependent on market conditions and management's expectations of the investment's value.[14]

The subject of hedging and price risk management activities encompassed yet another note to Enron's financial statements:

> Note. 3 PRICE RISK MANAGEMENT ACTIVITIES AND FINANCIAL INSTRUMENTS
>
> Enron offers price risk management services to wholesale, commercial and industrial customers through a variety of financial and other instruments including forward contracts involving physical delivery, swap agreements, which require payments to (or receipt of payments from) counterparties based on the differential between a fixed and variable price for the commodity, options and other contractual arrangements. Interest rate risks and foreign currency risks associated with the fair value of commodity portfolio are managed using a variety of financial instruments, including financial futures.... Notional amounts reflect the volume of transactions but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure Enron's exposure to market or credit risks.

SEC App. Tab 15, at 71-72. The disclosure of Enron's price risk management activities continued for six single-spaced pages in Enron's Form 10-K. *Id.* at 71-76. As it pertained to Enron's merchant investments, investors were told Enron might enter into hedges to moderate the impact of market fluctuations on these assets:

> Non-trading Activities. Enron also enters into financial instruments such as swaps and other contracts primarily for the purpose of hedging the impact of market fluctuations on assets, liabilities, production or other contractual commitments.

Id. at 74.

Finally, Enron described in detail how it accounted for its hedging and price risk management activities. This description, likewise, appears in a number of places, beginning in note 1, "Significant Accounting Policies."

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[14]SEC App. Tab 13, at 19; 14, at 19-20; 15, at 9, 38-39 (emphasis added).

> Note 1: SIGNIFICANT ACCOUNTING POLICIES
>
> Price Risk Management Activities.
>
> Enron engages in price risk management activities for both trading and non-trading purposes. Instruments utilized in connection with trading activities are *accounted for using the mark-to-market method of accounting*, forwards, swaps, options, energy transportation contracts utilized for trading activities and *other instruments with third parties are reflected at fair value and are shown as "Assets and Liabilities from Price Risk Management Activities" in the Consolidated Balance Sheet.* These activities also include the commodity risk management component embedded in energy outsourcing contracts. *Unrealized gains and losses from newly originated contracts, contract restructurings and the impact of price movements are recognized as "Other Revenues."* Changes in the assets and liabilities from price risk management activities result primarily from changes in the valuation of the portfolio of contracts, newly originated transactions and the timing of settlement relative to the receipt of cash for certain contracts. *The market prices used to value these transactions reflect management's best estimate* considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments.
>
> Financial instruments are also utilized for non-trading purposes *to hedge the impact of market fluctuations on assets*, liabilities, production and other contractual commitments. Hedge accounting is utilized in non-trading activities when there is a high degree of correlation between price movements in the derivative and the item being hedged. *In instances where the anticipated correlation of price movements does not occur*, hedge accounting is terminated and future changes in the value of the financial instruments *are recognized as gains or losses.* If the hedged item is sold, the value of the financial instrument *is recognized in income.* Gains and losses on financial instruments used for hedging purposes *are recognized in the Consolidated Income Statement in the same manner as the hedged item.*[15]

As a result of this disclosure, and similar disclosures throughout Enron's Form 10-K, investors were informed that Enron used hedges, including those where the hedge might not have a high correlation to the underlying asset it sought to protect. Investors were also told that Enron's gains or losses from hedging and Price Risk Management Activities were reflected: (1)

[15] SEC App. Tab 15, at 68-69 (emphasis added). *See also*, SEC App. Tab 2, at 78-79; 10, at 73-74.

on its Consolidated Balance Sheet as "Assets and Liabilities from price risk management activities"; (2) as "Other Income"; and (3) "in the Consolidated Income Statement in the same manner as the hedged item." Investors were thus made aware of how Enron accounted for its hedges, just as they were informed of what Enron's "price risk management activities" entailed.

2. Enron Disclosed the Risks Involved in The Related Party Hedging Transactions.

The Plaintiffs allege that investors were not told of the risks related to Enron's hedged investments with related parties.[16] Those allegations are not true. Enron disclosed to prospective investors that it was entering into hedges and financial derivative transactions with the related parties. "In 2000, Enron entered into derivative transactions with the Entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investments and other assets." SEC App. Tabs 15, at 95-96; 16, at 48. Enron further stated that its hedging and derivatives trading was dependent upon "[t]he ability of counterparties to financial risk management instruments and other contracts with Enron to meet their financial commitments to Enron,..." *See Id.* at 52-53; SEC App. Tab 10, at 56-57. Nowhere do Plaintiffs explain how a reasonable investor could have been misled about the credit risks of the Raptor structures, for example, when Enron expressly cautioned its investors that the results of these hedges, like the results of its hedges, were dependent upon the creditworthiness of its counterparties. *Id.*

Nor was Enron's credit risk statement some vague, generalized warning. To the contrary, Enron specifically told investors that the creditworthiness of the related party hedges was directly contingent upon the value of Enron common stock. As noted above, the amount of

[16]The related party transaction at issue also involved the Raptors which are addressed more specifically at Section III.B.2., *infra.*

Enron common stock issued or issuable to the related party was specifically disclosed in note 16 of Enron's consolidated financial statements. *See, e.g.,* SEC App. Tab 15, at 95-96. It also told potential investors that the hedges were structured in a fashion that might severely dilute Enron's public shareholders, and, in note 11, included the portion of then applicable dilution in the computation of diluted per share earnings. The relevant portions of Enron's specific disclosures of these risks are:

1. In the "Related Party" section, Enron disclosed that it had entered into a variety of derivative transactions with its related party that were collateralized by, among other things, "3.7 million restricted shares of outstanding <u>Enron common stock</u> and the right to receive up to 18.0 million shares of outstanding <u>Enron common stock</u>" that <u>Enron itself</u> had "<u>contributed to the newly-formed entities.</u>" *See* SEC App., Tab 15, at 95.

2. Enron's investors were also told, contrary to Plaintiffs' complaints,[17] of the potential dilutive effect of these transactions. Specifically, Enron disclosed that its hedges with the related party involved a significant amount of "share settled options" on, among other things, "21.7 million shares of <u>Enron common stock</u>." *Id.* Investors were told, therefore, that in calculating "diluted earnings per share" Enron included "the weighted-average number of common shares outstanding <u>plus the assumed issuance of common shares for all potentially dilutive</u> securities." *See* SEC App. Tabs 10, at 73; 15 at 68.

3. Enron also told investors it had "<u>derivative instruments on 54.8 million shares of Enron common stock, of which approximately 12 million shares are with JEDI and approximately 22.5 million are with related parties (see note 16)</u>, at an average price of $67.92 per share on which Enron was a fixed price payor. <u>Shares potentially deliverable to counterparties under the contracts are assumed to be outstanding in calculating diluted earnings per share unless they are anti-dilutive</u>. *See* SEC App. Tabs 10, at 90-91; 15, at 85-86, 95-96.

These disclosures, although accompanied by additional detail, told investors the facts that Plaintiffs now claim were concealed from them:

A. Enron contributed tens of millions of shares of its own stock to a related party;

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[17] See NCC at ¶ 620.

> B. Enron entered into hedges and derivative transactions with that related party;
> C.The hedges were secured, in large part, by the value of Enron's own common stock;
> D.Enron was directly exposed, in these derivative transactions, to the credit-worthiness of the related party and to "its ability to meet its financial obligations to Enron," and
> E.The structure of these hedges had the potential to be significantly dilutive to Enron's shareholders, so much so that the shares subject to the derivative contracts were already assumed to be outstanding for the purpose of calculating Enron's fully diluted earnings per share.

See SEC App. at Tabs 10 at 56-57, 90-93, 100-01; 15, at 52-53, 85-86, 95-96.

To suggest that investors were not told of the material facts and the significant risks associated with Enron's decision (a) to hedge investments (b) with a related party (c) whose creditworthiness and (d) hinged on the value of Enron's own common stock ignores what Enron disclosed about its related party transactions. "Where the warning is in specific language and relates not only to the riskiness of the investment but directly addresses the substance of the statement challenged by the plaintiffs, a reasonable fact finder could not conclude that the alleged misrepresentation 'would influence a reasonable investor's investment decision.'" *In re Waste Management Inc. Sec. Litig.* H-99-2183, Slip Op. at 104-05 n. 34, *citing In re Trump Casino Sec. Litig.*, 7 F.3d 357, 369-73 (3d Cir. 1993). Enron's related party disclosure, taken in context of its cautionary disclosures about counterparty credit risk, the use of derivatives on its own stock, and the potential dilutive effect of these transactions, was just such a warning.

3. ENRON INVOKED THE PSLRA'S SAFE HARBOR REGARDING ITS FORWARD-LOOKING STATEMENTS ABOUT HEDGING.

Enron expressly invoked the PSLRA's safe harbor in a disclosure central to Plaintiffs' claims that the credit risks of the related party transactions were concealed:

> This Report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act

> of 1934. All statements other than statements of historical facts contained in this document are forward-looking statements.... When used in this document, the words "anticipate," "*believe*," "estimate," "expects," "intend," "may," project," "plan," "should," and *similar expressions* are intended to be among the statements that identify forward-looking statements. Although Enron *believes* that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements *involve risks and uncertainties and no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include...the ability of counterparties to financial risk management instruments and other contracts with Enron to meet their financial obligations to Enron*; and Enron's ability to access the capital markets and equity markets during the periods covered by the forward-looking statements, which will depend on general market conditions and Enron's ability to maintain the credit ratings for its unsecured senior long-term obligations.

See SEC App. Tab 15, at 52-53 (emphasis added). Enron informed prospective investors that it's financial operations, including the successful outcome of its hedges and derivative transactions (which it had elsewhere disclosed in detail), could be adversely affected by counterparty credit risk. Statements regarding how these investments might perform in the future are, by definition, forward looking. *Compare* 15 U.S.C. Section 78u-5(I)(1)(A)-(C) *with* Enron's description of its hedging and derivative transactions. Forward looking statements are immaterial as a matter of law where, as here, they are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. Section 78u-5(c)(1)(A)(I).[18] Plaintiffs' suggestion that this risk was concealed or that meaningful cautionary language was not used, NCC at ¶ 985, is nonsense.

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[18]A statement is "forward looking" if, among other things, it is:

> (A) a statement containing a projection of revenues, income (including income loss) earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other financial items;

In addition, and independent of their forward-looking character, the cautionary disclosures Enron made were meaningful and were specifically directed to the transactions Plaintiffs attack. Contrary to Plaintiffs' assertion, Enron in fact apprised investors of the credit risk associated with (in Plaintiffs' words) the fact that the Related Party's "ability to make good...rested on the value of the Enron stock." *See* NCC at ¶¶ 456, 462, 463. Plaintiffs were also specifically cautioned about the fact that these transactions posed a risk of dilution to existing shareholders. *See* SEC App., Tab 15, ¶ 85-86, 95-96. Taken in context, these disclosures told investors the material facts and risks of these transactions.

C. ENRON'S DISCLOSURES OF ITS RELATED PARTY TRANSACTIONS WERE NOT MATERIALLY MISLEADING AND DID NOT OMIT MATERIAL FACTS.

The centerpiece of Plaintiffs' lawsuits is their allegation that Enron misrepresented transactions with related parties for the purpose of "hiding losses" and "concealing debts." Although Plaintiffs bear the burden to plead which of Enron's related party disclosures was allegedly misleading or inadequate, they failed to quote the full text of any of them. Just as

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(B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issues;

(C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission.

15 U.S.C. Section 78u-5(I)(1)(A)-(C); *see also In re BMC*, 183 F.Supp.2d at 895 & n. 28 ("The PSLRA establishes a 'safe harbor' shielding a 'forward looking statement' from ... liability where such a statement is made by a natural person unless [plaintiffs] prove that it was made with "actual knowledge" that the statement was false and misleading."). Moreover, whether a statement is "forward looking" or not, when accompanied by meaningful cautionary disclosures it may be rendered immaterial as a matter of law. *In re BMC,* 183 F. Supp. 2d at 888; *In re Trump Casinos*, 7 F. 3d 357,371 (3rd Cir. 1993).

tellingly, Plaintiffs also ignore significant disclosures by Enron that bear directly on its related party transactions and place them in context.

The Fifth Circuit and the PSLRA prohibit the Plaintiffs' vague approach to pleading fraud. "Materiality is not judged in the abstract, but in light of the surrounding circumstances." *Krim v. BancTexas Group*, 989 F.2d 1435, 1448-49 (5th Cir. 1993) (prospectus must be considered "as a whole"). This requires a court to "examine piecemeal the statements made by the company," *In re BMC*, 183 F. Supp. 2d at 880 n. 28, in order to determine whether taken as a whole they are materially misleading.

The Court will have no help from Plaintiffs in that effort. Although their complaints total more than 800 pages, Plaintiffs have failed to provide this Court with the actual disclosures made by Enron. They offer, instead, little more than lurid allegations, chaotic pleading and hyperbole. Plaintiffs are obligated to plead, with specificity, the "who, what, when and where" of Enron's allegedly misleading disclosures. *See Williams.*, 112 F.2d at 178. Having failed to meet this obligation, Plaintiffs' claims regarding the related party disclosures should be dismissed.

When the totality of Enron's disclosures is considered, it becomes apparent that Enron disclosed to prospective investors the information material to an understanding of the related party transactions and their effects on Enron-including the accounting policies and risks relevant to those transactions. [19] Enron also gave investors very specific and meaningful warnings about its use of hedges collateralized with Enron common stock, the significant credit and counterparty

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[19] The *Newby* Plaintiffs candidly assert that their Complaint is a "creative work" reflecting their "unique and original selection ...and arrangement" of their claims that Enron's disclosures were misleading. Defendants agree that it is creative in the extreme to contend that one could successfully plead a claim for the violation of the federal securities laws without once citing the text of an allegedly misleading or incomplete disclosure by the defendant.

risks faced by Enron, the potential of these transactions to dilute Enron's existing shareholders, and the underlying business risks inherent in Enron's merchant investment and price risk management activities. Enron also told investors which of its business interests were consolidated and which ones were not. These disclosures, in sum, told prospective investors everything Plaintiffs contend was concealed from them.

Plaintiffs fail to plead fraud with particularity as to any of their allegations concerning the related party transactions. In those rare instances where Plaintiffs have identified a transaction they challenge, Plaintiffs nonetheless fail to allege and plead specific facts to support that the transaction in question was material or fraudulent, or that any individual Defendant knew it was fraudulent at the time. Finally, in considering the adequacy of Enron's disclosures, it is important to bear in mind what is not at issue. Plaintiffs' criticism of Enron's decision to undertake related party transactions does not state a claim for securities fraud. Plaintiffs' criticism is essentially one of mismanagement. Allegations of mismanagement do not state a claim for securities fraud. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977). Enron's decision to restate certain transactions also does not, in itself, establish that any Defendant violated the securities laws. "A corporation does not admit that previous SEC filings <u>are misleading</u> every time that it amends or updates language in new filings." *Lovelace,* 78 F.3d at 1020 n.4. "GAAP violations may provide some evidence to raise an inference of knowing, or severe recklessness in not knowing, that a company's financial status was overstated, but only where a plaintiff specifies what the unreasonable practices were and how they distorted the disclosed data in transaction-specific detail." *In re Waste Management*, at 25 n.11. The fact that a handful of the related party transactions had adverse outcomes also does not state a claim of securities fraud. As the Third Circuit observed in *In re Glenfed Sec. Lit.*, 42 F.3d 1541 (9th Cir. 1994).

> What makes many securities fraud cases more complicated is that often there is no reason to assume that what is true at the moment [of Plaintiff's loss] was also true at the moment of the alleged misrepresentation, and that therefore simply because the alleged misrepresentation conflicts with the current state of facts, the charged statement must have been false. Securities fraud cases often involve some more or less catastrophic event occurring between the time the complained-of statement was made and the time a more sobering truth is revealed (precipitating a drop in stock price).... When such an event has occurred, <u>it is</u> clearly insufficient for plaintiffs to say that the later, sobering revelations make the earlier, cheerier statement a falsehood.
> 42 F.3d at 1548.

1. ENRON'S RELATED PARTY DISCLOSURES WERE ADEQUATE AND MUST BE CONSIDERED IN CONTEXT.

Plaintiffs concede that "Enron's publicly filed reports disclosed the existence of the LJM partnership." NCC at ¶ 67. However, Plaintiffs allege, generically, that Enron's disclosures "did not reveal the essence of the [related party] transactions completely or clearly and failed to convey the substance of what was going on between Enron and the partnerships." NCC at ¶ 67; TCC at ¶ 398, 417. Plaintiffs' allegation fails, however, to specify:

1. What specific material "facts" were allegedly undisclosed;
2. Who knew those facts;
3. When those "facts" became known to Enron or to any individual defendant;
4. Why those "facts" were material to a reasonable investor; and,
5. How those "facts" should have been, but were not, disclosed.

Williams, 112 F.2d at 178. *See also Nathenson v. Zonagen*, 267 F.2d 400, 412-13 (5th Cir. 2001). On that basis alone, Plaintiffs' claims concerning the related party transactions should be dismissed.

In fact, Enron disclosed "what was going on between Enron and the partnerships" in no less than six specific sections of Enron's Forms 10-K: the related party section; "Merchant Assets"; "Price Risk Management Activities and Financial Instruments"; "Summary of Significant Accounting Policies"; "Forward-Looking Statements"; and "Common Stock".

A. NOTE 15 REGARDING RELATED PARTY TRANSACTIONS AND RELEVANT SECTIONS OF ENRON'S PROXY STATEMENTS REVEALED THE MATERIAL TERMS OF THESE SECTIONS

In the Related Party disclosure in its 2000 Form 10-K, Enron made clear that:

1. "Enron entered into derivative transactions with the [Related Party] Entities with a combined notional amount of approximately $2.1 billion." SEC App. Tab 15, at 95-96.

2. These derivatives were done in order "to hedge certain merchant investments and other assets." *Id.*

3. "Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives." *Id.*

4. These revenues "offset market value changes of certain merchant investments and price risk management activities." *Id.*

5. These derivative transactions were entered into with an entity capitalized in part with "$3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003." *Id.*

6. "In addition, Enron recognized $44.5 million and $14.1 million of interest income and interest expense, respectively, on the notes receivable from and payable to the Entities." *Id.*

7. Enron also disclosed that the related party was comprised of "limited partnerships (the related party) whose general partner's managing member is a senior officer of Enron." *Id.*

8. Enron's proxy statement for all of the relevant years identified this senior officer or Enron's Chief Financial Officer, Andrew Fastow. See SEC App. Tabs 21, at 25; 22, at 26.

Enron's disclosures for 1999 were similarly detailed. *See* SEC App. Tab 15, at 95-96.[20] Even these limited quotations from Enron's related party disclosure illustrate that Enron disclosed what was material about these transactions. First, Enron disclosed that it had recognized more than $500 million in revenue from transactions with a related party in the year 2000.[21] Second, when it recognized $500 million in revenue from the related party hedges, Enron disclosed that it had done so because this revenue offset market value changes in its merchant investments and price risk management activities. Third, it disclosed that the counterparty to the transactions was capitalized in significant part with Enron common stock.

Although this disclosure alone sufficed to disclose to investors the material facts about these transactions, Enron's disclosures did not end there. Enron also made clear to investors what was encompassed within three key items discussed in the Related Party disclosures: "merchant investments," Enron's "hedging" activities, and its "price risk management activities."

B. NOTE 4 ENRON'S "MERCHANT INVESTMENTS" CONTAINED IMPORTANT AND ADEQUATE DISCLOSURES ABOUT THOSE

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[20]Investors did not even have to wait for Enron's annual 10Ks to learn particulars of Enron's related party transactions. Every quarter, Enron included a detailed "Related Party Transaction" disclosure in its 10Qs, containing the material information for the transactions completed that quarter. *See, e.g.,* SEC Ap. Tab 8, at 15 (6/99 Form 10Q); Tab 9, at 16 (9/99 Form 10Q); Tab 12 at p. 14 (3/00 Form 10Q); Tab 13, at 14 (6/00 Form 10Q); Tab 14, at 14 (9/00 Form 10Q); Tab 17, at 15 (3/01 Form 10Q) and Tab 18, at 16 (6/01 Form 10Q).

[21]Enron's 10-K for 1999 was equally detailed, in that it disclosed that LJM2 had "acquired approximately $360 million of merchant assets and investments from Enron, on which Enron recognized pre-tax gains of approximately $16 million. In December 1999, LJM2 entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million. Additionally, LJM or LJM2 acquired other assets from Enron for $11 million." *See,* SEC App. Tab 10, at 101.

RELATED PARTY TRANSACTIONS THAT INVOLVED MERCHANT INVESTMENTS.

Enron told investors what was encompassed within its "merchant investment" portfolio:

> Wholesale Services' businesses make investments in various energy and certain related assets as a part of its network strategy. Wholesale Services either purchases the asset from a third party or develops and constructs the assets. In most cases, Wholesale Services operates and manages such assets. Additionally, Wholesale Services invests in debt and equity securities of energy and technology-related businesses, which may also utilize Wholesale Services' products and services. *With these merchant investments*, Enron's influence is much more limited relative to assets Enron develops or constructs. Wholesale Services *uses risk management disciplines, including hedging transactions, to manage the impact of market price movements on its merchant investments.*

See SEC App., Tab 15, at 10. *See also* SEC App, Tab 17, at 21-22; SEC App. Tab 18, at 21.

Enron devoted an entire note in its financials to an explanation of its merchant investment activities:

> Note 4 MERCHANT ACTIVITIES
>
> Enron provides capital primarily to energy and technology-related businesses seeking debt or equity financing. The merchant investments made by Enron and certain of its unconsolidated affiliates (see Note 9) are carried at fair value and include public and private equity, government securities with maturities of more than 90 days, debt and interests in limited partnerships. The valuation methodologies utilize market values of publicly-traded securities, independent appraisals and cash flow analyses.... Merchant investments are recorded at fair value in 'Other Assets' with changes in fair value reflected in 'Other Revenues.'

See SEC App. Tab 15, at 76.

Enron also provided detailed disclosure of how Enron accounted for its merchant activities—even when they involved unconsolidated equity affiliates, and where they were reflected in its financial statements. When its merchant revenue came from an unconsolidated equity affiliate, Enron told investors it reflected on its balance sheet only the "amounts [that] represent Enron's investment in unconsolidated equity affiliates." *Id.* The operating earnings from those affiliates were "reflected in 'Equity in Earnings of Unconsolidated Equity Affiliates.'" *Id.* Thus, an investor who wanted to know more about Enron's merchant investments, and how they were accounted for, was told where to look in Enron's balance sheet and in its income statement to see how those activities affected Enron's financial health.

The related party disclosure, which specifically told investors that Enron was recognizing revenues because of changes in the market value of Enron's merchant investments, cannot be read in isolation from Enron's important disclosures regarding Enron's merchant investments activities. *See Krim*, 989 F.2d at 1448 (court should consider prospectus "as a whole"); *Spiegel v. Tenfold Corp.*, 2002 U.S. Dist. LEXIS 4618 *21 (C.D. Utah 2002) (same). These disclosures establish that Enron told its investors what was encompassed within its merchant activities, how it accounted for them (using the mark-to-market fair value methods), and where and how the revenues from its merchant investment activities were reflected in its financial statements.

Plaintiffs fail to plead with particularity any alleged falsity in these disclosures. Instead, they choose to ignore them entirely.

C. ENRON SPECIFICALLY DISCLOSED ITS RELATED PARTY ACCOUNTING PRACTICES.

The related party disclosure specifically referred to "merchant assets," to "hedging," and to "price risk management activities." All of these, together with a description of how they are accounted for, are described in detail elsewhere in Enron's 10-K. When considered in the context of these additional disclosures, the related party disclosure is not materially incomplete or misleading: Enron disclosed the significant effect the related party transactions had on Enron's revenues, cash flows and diluted earnings per share. It told investors that these revenues and cash flow and earnings adjustments were the direct result of transactions with a related party run by one of its senior officers.[22] The related party disclosure also clearly indicates that the counterparty to the related party hedges is capitalized substantially by Enron common stock. Note 11, "Common Stock" discloses both the amount (22.5 million shares) and the average price ($67.92) of shares which Enron might be obligated to issue to such related party, which were included to the extent dilutive in determining diluted earnings per share. Finally, Note 6, "Supplemental Cash Flow Information," discloses the fact that related party transactions resulted in a non-cash increase in the common stock component of cash flow of $171 million. *See*, SEC App. Tab 15, at 78-79, 85-88.

The related party disclosure also told the interested investor that the impact of the related party transactions was reflected in Enron's financial statements in five separate places. First, the cumulative impact of these transactions--$500 million in revenue and an additional $44.5 million in interest income and $14.1 million in interest expense—was reflected in the related party disclosure itself. See SEC App. Tab 15, at 95-96. Second, Enron told investors that the portion of these revenues attributed to a decline or change in the market value of Enron's merchant investments was accounted for within the financial disclosures pertinent to its merchant investments. *Id.* at 76. Third, the portion of those revenues resulting from Enron's hedging activities was reflected in the balance sheet and income statement items pertinent to its "price risk management activities." *Id.* at 68-69, 71-76. Fourth, the per share earnings effects of the transactions with the related party were disclosed in note 11. *Id.* at 85-88. Finally, the cash flow effect was disclosed in note 6. *Id.* at 78-79.

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[22]In its Proxy Statement, as will be discussed in greater detail below, Enron disclosed that this officer was Andrew Fastow, its Chief Financial Officer. *See* SEC App. Tab 21, at.25.

Plaintiffs make no effort to explain how these disclosures failed to tell investors "what was going on" between the partnerships and Enron as it pertained to the revenues derived from these transactions. NCC at ¶ 67. In fact, Plaintiffs fail to quote the full text of even one of Enron's very detailed disclosures, and thus fail to explain why these statements were fraudulent or deceptive. Without a particularized allegation of what facts were concealed in these disclosures, by whom, when they were known, and how these "facts" should have been disclosed, *Williams*, 112 F.2d at 178, Plaintiffs have failed to state a claim for relief.

2. PLAINTIFFS' ASSERTION THAT THE TERMS OF THE RELATED PARTY TRANSACTION "WERE NOT" REASONABLE DOES NOT STATE A CLAIM.

Plaintiffs also contend that Enron falsely "represented that the related party transactions were reasonable compared to transactions with third parties when, in fact, they were not." NCC at ¶ 67. Plaintiffs ignore the text of what Enron said. Plaintiffs also ignore their obligation to plead with particularity (a) the statements Plaintiffs contend were false; (b) where these statements were made; (c) why they were allegedly false and misleading; (d) when it was that Plaintiffs contend Enron knew the allegedly "true but concealed facts"; and (e) why the statements Enron made about the reasonableness of the related party transactions were false and misleading and (f) how and why the transactions were unreasonable in fact. *Nathenson*, 267 F.2d at 412-13; *Williams* 112 F.3d at 177. Finally, Plaintiffs ignore other disclosures that render immaterial Enron's statement that its management "believed" the terms of the related party Transactions were reasonable.

Interestingly, Plaintiffs rarely quote the language they contend was misleading in the related party disclosures. Had they done so, it would become apparent that—far from guaranteeing the results of these transactions—Enron's management[23] expressed an opinion about the reasonableness of these transactions and coupled its opinion with meaningful cautionary disclosures about how the results of the transactions might differ from what they expected.

A. STATEMENTS OF "BELIEF" BY MANAGEMENT CONCERNING THE "REASONABLENESS" OF THE TERMS OF THESE TRANSACTIONS WERE FORWARD-LOOKING AND, IN ANY EVENT, WERE TOO VAGUE TO BE MATERIAL TO A REASONABLE INVESTOR.

> *Management believes* that the terms of the transactions with related parties *are representative of terms* that would be negotiated with unrelated third parties. *See* SEC App. 10, at 101 (emphasis added).
>
> *Management believes* that the terms of the transactions with the related party were *reasonable* compared to those which could have been negotiated with unrelated third parties. *See* SEC App. Tab 15, at 95 (emphasis added).
>
> *Management believes* that the terms of the transactions *were reasonable and no less favorable* than the terms of similar arrangement with unrelated third parties. *See* SEC App.Tab 22, at 30 (emphasis added).
>
> *Management believes* that the terms of the transactions were *reasonable and no less favorable* than the terms of similar arrangements with unrelated third parties. *See* SEC App. Tab 21, at 30 (emphasis added).

This expression of "belief" by Enron management was expressly denominated as a "forward looking statement" by Enron in its disclosures. See SEC App. Tab 10, at 56; 15, at. 52 ("when used in this document, the words .... believe, estimate ... may and similar expressions are intended to be among the statements that identify forward looking statements."). Enron

[23]Plaintiffs fail to identify who in Enron's management held or did not hold a belief concerning the reasonableness of the related party transactions at the time this statement was made. That failure to specify "who" made this alleged misstatement is yet another basis upon which this claim must be dismissed. *See Williams*, 112 F.3d at 177.

invoked the PSLRA's safe harbor when cautioning prospective investors not to rely on statements of "belief" by its management. *Id.*

A statement that management "believed" the terms of the related party transactions were "reasonable," *see e.g.* SEC App. Tabs 10 at 101; 15 at 95, is in any event too vague and general to support a claim of fraud. Courts have regularly rejected claims of fraud similarly premised on subjective statements of opinion or optimism. *See e.g. Nathenson*, 267 F.3d at 419, *see also Kurtzman v. Compaq Computer Corp.,* H-99-779, Slip Op. at 51-56. While Plaintiffs may differ with Enron's use of the term "reasonable" to describe management's belief about these transactions, "the defendants were under no duty to 'employ the adjectorial characterization' that the plaintiffs believe is more accurate." *Tuchman,* 14. F3d. at 1069 *quoting Int'l. Business Machines Corp.*, 796 F.Supp. 1120, 1126 (N.D. Ill. 1992). Just as "reasonable minds can differ," Enron's statement of its management's subjective belief that the terms of these transactions were "reasonable" is too vague to be legally material to a reasonable investor. Accordingly, without any allegation that Enron believed the contrary to be true when it made this statement, Plaintiffs' claims concerning the "beliefs" of Enron's management fail to state a claim for relief. *See Williams*, 112 F. 3d at 177-78 (dismissing claim that failed to plead <u>why</u> a particular statement was materially misleading).[24]

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[24]Plaintiffs' claim also fails, of course, because it fails to plead with specificity <u>who</u>, if anyone, in Enron's management, allegedly believed these transactions were "unreasonable" at the time they were entered into. *Id.*

B. PLAINTIFFS FAIL TO ALLEGE THAT "ENRON MANAGEMENT" KNEW THE TERMS OF THESE TRANSACTIONS WERE ALLEGEDLY "UNREASONABLE."

Plaintiffs, although they attack the "reasonableness" of some of these transactions (though they never identify which ones), never plead that Enron's management knew the terms of the related party transactions were unreasonable when they expressed a "belief" that they were "reasonable compared to [terms] that could have been negotiated with a third party." *See e.g.* SEC App. Tab 15, at 95. The holding of the Fifth Circuit in *Lovelace* is directly relevant: Plaintiffs "allegation tells us nothing about whether the Defendants knew that any of their prior disclosures 'were materially false or misleading *when made*'" 78 F.3d at 1020 n.4. (emphasis added). Plaintiffs' failure to allege when or if Enron knew the terms of the related party transactions "were not" reasonable, or what steps it took when it allegedly learned that "fact," is insufficient to plead fraud with particularity. *See Williams*, 112 F.2d at 178 (stating that Plaintiff must allege "when" a defendant learned that its statement was false). It fails even more profoundly when one considers that Plaintiffs: (a) never allege that even one of the more than 80 defendants harbored a belief that this statement was misleading when it was made; and (b) never identify which of the particular transactions they allege were unfair.

Nor does Plaintiffs' conclusory assertion that the terms of the related party transactions "were not" reasonable suffice to defeat a motion to dismiss. "Conclusory allegations or legal conclusions masquerading as factual conclusions do not defeat a motion to dismiss." *In re BMC Sec. Litig.*, 183 F.Supp. 2d at 888, n. 13 *citing Shushany v. Allwaste, Inc.*, 992 F.2d 517, 520, 523 (5th Cir. 1993); *Tuchman*, 14 F.3d at 1067 (5th Cir. 1994) (stating that courts should "not accept as true conclusory allegations or unwarranted deductions of fact"). In the absence of facts supporting an inference that Enron or any defendant actually believed this disclosure was false "when made,'" *Lovelace*, 78 F.2d at 1020, n.4, Plaintiffs have failed to plead fraud with particularity. *See In re BMC*, 183 F.Supp.2d at 889-90 ("Nor does the complaint indicate how any of these adverse facts came to light, how Defendants learned about them, or whether Defendants made any statements after learning about them.").

C. FRAUD BY HINDSIGHT DOES NOT STATE A CLAIM FOR RELIEF.

It is not enough for Plaintiffs to allege that the transactions were "unreasonable" because they "turned out" badly for Enron. *See In re Glenfed*, 42 F.3d at 1548. At most, that is a claim of mismanagement that is not actionable under the securities laws. *See Santa Fe Indus.* 430 U.S. 462. The suggestion that some transactions *may* have been unfair is irrelevant to whether Plaintiffs have pled that any individual *Defendant* actually believed the transactions were unfair <u>at the time</u> Enron entered into them. "Corporate mismanagement does not, standing alone, give rise to a 10b-5 claim, and meas culpa does not sufficiently satisfy the scienter requirements of pleading in securities fraud cases." *Tuchman,* 14 F.3d at 1070 (5th Cir. 1994). "The party must know that it is publishing materially false information, or the party must be severely reckless in publishing such information.'" *Fine v. American Solar King Corp.*, 919 F.2d 290, 297 (5th Cir. 1990); *Lovelace*, 78 F.3d at 1020.

A corporation acts through its directors and officers, so the absence of any pleading that the directors and officers knew these transactions were unfair at the time is dispositive of any intent to defraud on their part—or on the part of Enron itself. *See Coates v. Heartland Wireless Communications, Inc.*, 56 F. Supp. 2d 628, 633 n.3 (N.D. Tex. 1999) (to hold a corporate defendant liable, a plaintiff must adequately plead that an individual natural person, whose actions may be imputed to the corporation, made the statement with scienter). As a result, Plaintiffs' dramatic allegations concerning Enron's subsequent realization of losses on the LJM transactions, its decision to unwind the Raptor structures, and its restatement of financial results pertaining to certain of those transactions "tell us nothing about whether the Defendants knew that any of their prior disclosures were materially false or misleading *when made*. A corporation does not admit that previous SEC filings <u>are misleading</u> every time that it amends or updates language in new filings." *Lovelace*, 78 F.3d at 1020 n. 4. Plaintiffs' "complaint contains no assertion of any fact that makes it reasonable to believe that the defendants knew that any of their statements were materially false or misleading when made." *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1069 (5th Cir. 1994).

3. PLAINTIFFS PLEAD NO FACTS TO SHOW THAT ENRON'S DISCLOSURE OF ANDREW FASTOW'S FINANCIAL INTEREST IN THE LJM PARTNERSHIPS WAS INACCURATE OR MISLEADING WHEN MADE.

In their next allegation concerning the related party disclosure, Plaintiffs contend that Enron made an incomplete disclosure of Andrew Fastow's financial interest in the LJM partnerships. *See* NCC at ¶ 67 (failure to "fully disclose nature or extent of Fastow's financial interests . . ."). Plaintiffs plead no further facts to support a claim that Enron's disclosure of Fastow's interest in the LJM partnerships was inaccurate or misleading when made. Enron disclosed that Fastow was the "managing member" of LJM's general partners and "entitled to receive a percentage of profits of LJM in excess of the general partner's proportion of the total capital contributed . . .." This is the "nature" and "extent" of Fastow's financial interest. The amount of such compensation was based, as disclosed, on a percentage of *profits*, and was therefore "unknowable" until the profits of the partnerships were known.

Importantly, Plaintiffs also fail to plead that any Defendant knew more about Mr. Fastow's compensation than what was actually disclosed by Enron. For these reasons, Plaintiffs have again failed to establish either the existence of a material misrepresentation or an omission by any Defendant concerning the matter of Mr. Fastow's compensation.

As they do throughout the Complaint, Plaintiffs assert—without citation—that Enron's disclosures were unclear about how Mr. Fastow would be compensated by the LJM Partnerships. This assertion is belied by what Enron disclosed about Mr. Fastow's compensation in its proxy statements. In a section entitled "Certain Transactions," Enron told its shareholders:

> In June 1999, Enron entered into a series of transactions involving a third party and LJM Cayman, L.P. ("LJM1"). LJM1 is a private investment company that primarily engages in acquiring or investing in energy and communications related investments. *Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron, is the managing member of LJM1's general partner. The general partner of LJM1 is entitled to receive a percentage of profits of LJM1 in excess of the general partner's proportion of the total capital contributed to LJM1, depending upon the performance of the investments made by LJM1.*
>
> * * *
>
> In the second half of 1999, Enron entered into eight transactions with LJM1 and LJM2 Co-Investment, L.P. ("LJM2"). LJM2 is a private investment company that primarily engages in acquiring or investing in energy and communications related investments. *Mr. Fastow is the managing member of LJM2's general partner. The general partner of LJM2 is entitled to receive a percentage of the profits of LJM2 in excess of the general partner's proportion of the total capital contributed to LJM2, depending upon the performance of the investments made by LJM2.*
>
> * * *

See SEC App. Tab 21, at 26-27 (emphasis added).

Plaintiffs' claims of inadequate disclosure in the face of this disclosure are not saved by Plaintiffs' repeated incantation of what they claim are the "true but concealed facts." *See e.g.*

NCC at ¶¶ 121, 155, 214, 300, 339. They nowhere cite any fact to establish that the disclosures, when made, were false or that Enron or any Defendant knew, at the time it made this disclosure, that it was false of misleading. *See In re BMC*, 183 F. Supp. 2d at 917 (Plaintiffs have also failed to provide the necessary specific allegations to support their lists of 'concealed facts' purportedly known to Defendants when they made misleading statements."). That Enron has since discovered that Fastow made a great deal of money based upon the performance of the partnerships does not render those disclosures misleading at the time they were made. "Such an allegation tells us nothing about whether the Defendants knew that any of their prior disclosures 'were materially false *when made*." *Lovelace*, 78 F.2d at 1020, n.4 (emphasis original); *accord In re Craftmatic Sec. Lit.,* 42 F.3d 1541, 1548 (9th Cir. 1994) ("In the face of such intervening events, a plaintiff must set forth, as part of the circumstances constituting fraud, an explanation as to why the disputed statement was untrue or misleading *when made*.").

4. ENRON'S FAILURE TO CONSOLIDATE CERTAIN PARTNERSHIPS AND SPES DOES NOT STATE A CLAIM FOR SECURITIES FRAUD.

Plaintiffs make general allegations about Enron's failure to consolidate certain Special Purpose Entities, such as JEDI, LJM and "Cortez, Rawhide, Margaux, Fishtail, JGC Trust and LAB Trust, [and] LJM1 and LJM2…" NCC at ¶ 476; TCC at ¶ 402. Plaintiffs' claims fail on three, independent grounds: (a) Enron disclosed the material facts about those entities that were not being consolidated in notes related to "Unconsolidated Equity Affiliates" or "Related Party Transactions," *see* SEC App. Tabs at 10, at 86-89; 100-01; 15, at 82-84, 95-96 (b) the application of disputed accounting principles does not constitute a misstatement when the existence of the dispute is itself disclosed, and (c) a restatement of financial results does not, without more, state a claim for securities fraud.

A. ENRON DISCLOSED THE MATERIAL FACTS ABOUT ITS UNCONSOLIDATED ENTITIES.

Plaintiffs' claim Enron "hid" its debt in off-balance sheet entities. NCC at ¶ 3, 98, 99 418(a), 506, 652, 803; TCC at ¶ 2. Enron's disclosures, and the statements made in analyst reports contradicts this claim.[25] In its Forms 10-K, Enron identified for investors ten "unconsolidated equity affiliates." *See* SEC App. Tabs 10, at 87; 15, at 82. These affiliates included "Azurix, Dabhol, JEDI, JEDI II, ... Whitewing" and "other" unspecified affiliates. *Id.* Enron disclosed to investors its investments and advances to these entities, together with their earnings and losses. *Id.* It also disclosed "[S]ummarized combined financial information of Enron's unconsolidated affiliates" including their "current assets, ... current liabilities, long-term-debt, and other non-current liabilities." *Id.* Collectively, the liabilities of these unconsolidated entities were $15.2 billion in 1999 and $20.5 billion in 2000. *Id.* Enron also disclosed its transactions with Whitewing, *id.*, the fact that the New Power company had sold New Power convertible warrants to LJM, *id.*, and the earnings Enron had realized from its relationship with these unconsolidated equity affiliates. *Id.* There is no fair argument that Enron "hid debt" in these unconsolidated affiliates when that debt, in the amount of tens of billions of dollars, was disclosed in Enron's Form 10-Ks.

B. THE FAILURE TO CONSOLIDATE IS NOT SECURITIES FRAUD.

A hindsight analysis of alleged mistakes under GAAP does not state a claim under the securities laws. *Lovelace*, 78 F.3d at 1020. "The mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter. The party must

[25] The Analyst Reports are discussed *infra* at Section VI.A.

know that it is publishing materially false information or the party must be severely reckless in publishing such information." *Fine v. American Solar King Corp.*, 919 F.2d 290, 297 (5th Cir. 1990); *Lovelace*, 78 F.3d at 1020. This is particularly true because

> The term 'generally accepted accounting principles,' as we have often noted, is a term of art encompassing a <u>wide range of acceptable procedures</u>, such that `an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures when that accountant prepares a financial statement.'

Id. at 1020-21 (emphasis added).

Here, Plaintiffs fail to state a claim regarding the non-consolidation of these entities for three reasons. First:

> as a general rule, failure to follow GAAP, without more, does not adequately plead scienter. Here, the public records reveal that Arthur Andersen concurred that the financial results of BGS were immaterial to BMC's financial position and were not required to be combined with BMC's results and restated. Even if Defendants were mistaken, however, the mere failure to follow GAAP does not, in itself, establish scienter.

In re BMC, Inc. Sec. Litig., H-99-715 Slip Op. at 27 (S.D. Tex. June 15, 2000). Second, Plaintiffs do not contend that any individual defendant knew (at the time these entities were not consolidated) that these entities "should have been consolidated." Third, Plaintiffs do not allege when that consolidation should have occurred or <u>why</u>, under particular accounting rules, these entities "should have been" consolidated. Moreover, they do not allege which (if any) of these entities actually was material to Enron's financial results. *See Lovelace*, 78 F. 3d at 1020. Plaintiffs' generalized "consolidation" claim fails to state a claim for relief.

Plaintiffs' fail to state a claim on this count for at least two additional reasons. First, Enron disclosed the existence of JEDI and the fact that it was a significant contributor to Enron's unconsolidated debt. *See* SEC App. Tabs 10, at 87; 15, at 82. Enron made similar, detailed disclosures about the extent of the debts owed to Enron by related parties. *Id.* at Note 16 (disclosing promissory notes to Enron in excess of $1.5 billion in 2000). Enron also disclosed that it was not consolidating either the financial results of JEDI, or those of LJM, with its own. *Id.* and at Note 16. That does not mean, however, that Enron "concealed" or "hid" from investors the amount of debt held at these off balance sheet entities. To the contrary, those debts were disclosed in Enron's 10-Ks. *Id.* Plaintiffs do not state a claim for securities fraud by alleging that certain entities were "improperly" given unconsolidated treatment. Unless that treatment is alleged to have been put in place by an individual defendant, who knew the treatment was improper, for the purpose of misleading investors, Plaintiffs have—at most—stated a claim of accounting negligence when they allege that these entities should have been consolidated. Accounting negligence and differences of business judgment, however, do not violate the securities laws. *Lovelace*, 78 F.3d at 1020.

No misstatement is made when a company applies disputed accounting principles and discloses the way in which it applies them. *Id.* The question whether an investment must be consolidated has been a matter of considerable complexity in the accounting literature. Public companies and their professional advisors and auditors have received little guidance from the accounting profession or the SEC concerning how these standards should be applied to disclosures of particular types of transactions. There is no question that Enron's management and auditors were required, as they disclosed, to make judgment calls in deciding whether particular entities could be reported as deconsolidated in Enron's financial statements.[26]

[26] *See* SEC App. Tab 15, at 67-70, "Summary of Significant Accounting Policies"("The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of

Investors were cautioned, in fact, that in applying GAAP to its activities, Enron's assumptions could be critical and its results might differ from its own estimates.[27]

Although Plaintiffs suggest that the consolidation rules were a matter of mechanical application, NCC at ¶432; TCC at ¶¶ 288-89, that was not the case. In fact, so confusing were the relevant rules Enron was called upon to apply that—in light of Enron's experience--the accounting profession requested that the SEC issue an interpretive release to clarify matters pertaining to the reporting of off-balance sheet, deconsolidated and related party entities. *See* SEC Release Nos. 33-8056; 34-45321; FR-61, "Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations." In this Release, the SEC noted that it had received a petition requesting additional guidance regarding how to include in annual reports "liquidity and capital resources, including off-balance sheet arrangements; ... and, relationships and transactions with persons or entities that derive benefits from their non-independent relationships with the registrant or the registrant's related parties." *Id.* This release and the circumstances that led to its issuance illustrate that the standards applicable to the disclosure of related party and deconsolidated entities were confusing *even to professional accountants*. In the face of this confusion Enron's decision to choose one accounting standard over another is at most a difference with the accounting judgment Plaintiffs now contend it

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assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates."). Enron went on to disclose one example of the kinds of judgments that might be required in connection with the decision to consolidate assets ("Where acquired assets are accounted for under the equity method based on <u>temporary control</u>, earnings or losses are recognized only for the portion of the investment to be retained."), *see id.* at 69-70 "Investments in Unconsolidated Affiliates."

[27] *Id.*

should have made. "A difference in judgment about generally accepted accounting principles does not establish conscious behavior on the part of Defendants." *Lovelace*, 78 F.3d at 1020-21. This is particularly true when the details of the allegedly "concealed" transactions were disclosed in Enron's financial statements anyway. As has been indicated above, Enron gave investors very detailed disclosures of which entities were consolidated, which were not, and how each was accounted for. A claim of securities fraud requires, first and foremost, the existence of a material misstatement or omission. *See* 15 U.S.C. Sections 77k and 78j. When facts are disclosed, as they were here, nothing is misstated.

Moreover, Plaintiffs do not dispute that Enron's unconsolidated treatment of these entities was reflected year after year in financial statements that were audited by Arthur Andersen, with no indication that the firm believed Enron's accounting treatment was incorrect. *See* SEC App. at Tabs 6, at 79; 10, at 66; 15, at 61-62, 1998, 1999 and 2000 Forms 10-K at "Auditors' Opinions." It also negates any inference of scienter on the part of the individual Defendants—particularly given that Plaintiffs have not plead that any of the individual Defendant knew at the time that deconsolidated treatment was improper. *In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 864-65 (N.D. Cal. 1993).

Finally, Plaintiffs' claims regarding the failure to consolidate JEDI and LJM are not saved by the fact that Enron subsequently restated certain aspects of those transactions. As this Court observed in *In re Waste Management*, the mere fact that there has been a restatement does not suffice to state a claim of securities fraud. "GAAP violations may provide some evidence to raise an inference of knowing, or severe recklessness in not knowing, that a company's financial status was overstated, but only where a plaintiff specifies what the unreasonable practices were and how they distorted the disclosed data in transaction-specific detail." *In re Waste Management*, at *185*. Here, as in *In re Waste Management*, although Plaintiffs have catalogued the restated items in Enron's financials, it has "failed to demonstrate any particularity" as to even one transaction—including why the transaction in question allegedly violated GAAP, who knew that it did or when that fact became apparent to any individual defendant. *Id.*[28] Plaintiffs' sweeping and non-specific allegation that Cortez and other entities "should have been consolidated" is therefore too vague to require any further rebuttal. *See* Fed. R. Civ. P. 9(b); *Williams* 117 F.2d at 183 (complaint fails to state a claim when it fails to specify the who, what, when and where of the allegedly fraudulent statements).

5. PLAINTIFFS' "LAUNDRY LIST" OF RELATED PARTY TRANSACTIONS FAILS TO PLEAD FRAUD WITH PARTICULARITY.

In a generic allegation repeated throughout their Complaints, Plaintiffs assert that:

> The partnerships were used by Enron management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions were designed to accomplish favorable financial results, i.e. not to achieve bona fide economic objectives or to transfer risk. Other transactions were implemented improperly to offset losses. They allowed Enron to conceal from the market very large losses from Enron's merchant investments by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake. These transactions resulted in Enron reporting earnings from the 3rdQ 00 through the 3rdQ01 that were almost $1 billion higher than should have been reported.

NCC at ¶ 385. This paragraph (like the rest of Plaintiffs' Complaints) fails to place the Defendants on notice of their alleged fraud. The fact that Enron "would not" allegedly have

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[28]A more detailed explanation of why Enron's restatement of financial results fails to state a claim for securities fraud is found in the section of this brief entitled "Restatements.' *See infra* Section IV.

done these transactions with unrelated entities is not fraudulent. Parties to contracts choose to do business with one another for a variety of reasons; by definition that is an exercise of management discretion. Mismanagement is not actionable under the securities laws. *See Santa Fe Indus.,* 430 U.S. 460.

Plaintiffs' allegation that "many of the most significant transactions were done to accomplish favorable financial [statement] results rather than bona fide economic objectives or to transfer risk" is not an allegation of fraud. Plaintiffs fail to particularize any accounting principle at issue. If the issue is one of presentation, the choice of how to account for a transaction is a matter of art; that a business chooses one presentation over another is not fraud so long as it does so in good faith, and in the genuine belief that the treatment it has chosen is correct. *Lovelace*, 78 F.3d at 1020-21. Importantly, Plaintiffs elsewhere plead that Enron applied its chosen accounting treatment to these transactions with the concurrence of Andersen, which issued unqualified audit opinions to Enron, and with the aid of structuring advice in advance from both Andersen and Vinson & Elkins. *See* NCC at ¶ 221-292. Those facts, as pleaded by Plaintiffs, are inconsistent with any inference of fraudulent intent by Enron. More important to this purpose, they state no claim at all against the individual Defendants, none of whom is mentioned in these allegations. Finally, Plaintiffs cannot assert a claim of securities fraud without identifying the transactions they are talking about or why they were allegedly fraudulent. *See Williams*, 112 F.2d at 178. Allegations raising questions about "the most significant (unnamed) transactions," NCC at ¶ 385, do not suffice under Rule 8, much less under Rule 9(b).

The same is true of allegations that transactions were "implemented improperly" to offset losses. Improper implementation is a claim of mismanagement, *Santa Fe Indus.,* 430 U.S. 460, and Plaintiffs do not allege in this paragraph that Enron did anything other than fail to achieve the legitimate objective of trying to offset or avoid losses on its investments.

Plaintiffs claim that these (unidentified) transactions "allowed Enron to conceal from the market very large losses resulting from Enron's merchant investments," NCC at ¶ 385, is simply wrong. Nothing at all was concealed about the losses Enron suffered on its merchant portfolio; to the contrary, Enron's disclosures told investors that the related party hedges "offset market value changes of certain merchant investments and price risk management activities." See SEC App, Tab 15, at 95-96 (2000 Form 10K). Investors were also told where in Enron's Forms 10-K they could locate these losses and the other effects of these transactions on Enron's financial health. *See supra* at 95-96. Finally, Enron disclosed that the related party hedges were collateralized with millions of shares of Enron stock that had been contributed to these entities by Enron. *See Id.* That Plaintiffs assert a fact was concealed, when the disclosures establish that the facts were revealed, cannot state a claim of fraud.

Plaintiffs then state, in conclusory fashion, that "these transactions resulted in Enron reporting earnings that were almost $1 billion higher than should have been reported." Plaintiffs fail, however, to identify which transactions are at issue, why Enron's earnings from them were "higher than [they] should have been," when Enron should have known these revenues were too high, and who is at fault. This fails to comply with Plaintiffs' pleading obligations under Rule 9(b). *See In re Waste Management,* at 185-86.

As is indicated below, Plaintiffs' other allegations regarding the related party transactions are similarly devoid of content. Plaintiffs fail to state with particularity what was misleading about the transactions they actually attack, when it became known that these transactions were "manipulative transactions with LJM," NCC at ¶¶ 466-476, to whom that 'fact' became known, and why what Enron disclosed about these transactions was materially misleading. *Id.* Plaintiffs cannot 'dump long lists' into the complaint, *Wenger*, 2 F.Supp. 2d at 1244, and then contend they have met their pleading burden. To permit them to do so "makes a mockery of Rule 9(b) and the [PSLRA]." *Id.*

6. PLAINTIFFS' CLAIMS CONCERNING CUIABA, MEGS, CLO, NOWA SARZYNA, BACKBONE, AND YOSEMITE DO NOT ALLEGE ACTIONABLE FRAUD UNDER 9(B).

Plaintiffs contend that Enron and LJM engaged in "at least another 20 manipulative transactions from 9/99 through 7/01. These included ... Cuiaba, ENA CLO, Nowa Sarzyna, Aryan, MEGS, Yosemite [and] Backbone." *See* NCC at ¶¶ 467-475. Plaintiffs do not bother to identify fourteen of the allegedly manipulative transactions. Even as to those transactions they have identified by name, Plaintiffs fail to specify why each was allegedly "manipulative," how the particular transaction was material to an investor, where it should have been disclosed, and when (and to whom) it was known that the transaction had created adverse outcomes for Enron. Finally, nowhere in the list of allegedly "manipulative" transactions entered into by Enron and LJM do Plaintiffs identify even one individual Defendant who knowingly participated in the unspecified "manipulation" at issue in this claim. For the reasons stated in this Court's opinion in *In re Waste Management*, and those stated by the Fifth Circuit in *Lovelace* and in *Williams*, these allegations fail to comply with Rule 9(b) and should be dismissed.

As a matter of substance, moreover, Plaintiffs fail to allege that most of these transactions were even fraudulent.

A. Cuiaba

Plaintiffs lodge, in essence, two complaints about Cuiaba. NCC at ¶¶ 467-68. First, they contend that Cuiaba was deconsolidated improperly--but fail to state why this was so, who knew it, or when that flaw became apparent. They also fail to allege that the income recognized on this transaction was material to Enron. Plaintiffs provide no particulars to support their allegation that the recognition of this income was "improper." Finally, Plaintiffs assert—without any supporting detail--that "Enron had agreed to make LJM whole for its investment." NCC at ¶ 468. This allegation is too vague to support a claim of misrepresentation against individual Defendants who are not even named in this allegation.

B. Enron CLO

In this allegation, Plaintiffs allege that two off balance sheet entities—Whitewing and LJM2—purchased "the lowest rated tranches" of a pooled group of Enron notes receivable. NCC at ¶ 469. The remainder of Plaintiffs' allegation is set out below:

> Two days before LJM2 paid $32.5 million for its interest in the CLO's, Whitewing loaned LJM2 $38.5 million. Whitewing investors were in turn assured by Enron that they "would be made whole" on the transaction. There was no economic substance to LJM2's investment in the loans, and the transaction was done solely to allow Enron to improperly record the sale of loans as income in 99. Enron eventually repurchased all of the outstanding Notes at par plus accrued interest. Enron also repurchased LJM2's equity stake at cost.

Plaintiffs elsewhere allege that LJM2 was a private equity fund with hundreds of millions of dollars in funds raised from institutional investors. *See* NCC at ¶ 460; TCC at ¶ 101, 318. More important, Whitewing and LJM2 (and their investors) are not the plaintiffs in this case—and

Plaintiffs make absolutely no effort to explain how this transaction was either injurious to Enron or material to Enron's prospective investors.

Plaintiffs can make no allegation that this transaction injured Enron's prospective investors. Plaintiffs admit the Enron CLO's were a pool of notes receivable owed to Enron. See NCC at ¶ 469. A prospective investor is not injured or misled by a company's decision to factor its receivables. Nor can a prospective investor realistically assert a claim of fraud if, for its own business reasons, a company later repurchases its factored receivables. At a minimum, in the absence of any specifics at all as to why these transactions were allegedly fraudulent, how they misled potential purchases of Enron stock (as opposed to investors in Whitewing or LJM), how they were material to Enron (which was in any event exposed to the credit risk of these notes receivable), or who knew of the allegedly "improper" nature of this transaction, Plaintiffs have failed to plead a claim against any individual Defendant in compliance with Rule 9(b). *Williams*, 117 F.3d at 183.

C. NOWA SARZYNA (POLAND POWER PLANT)

In a paragraph again devoid of any allegation against any individual Defendant, Plaintiffs complain of Enron's failed effort to sell its interest in a power plant in Poland. NCC at ¶ 471. Stripped of rhetoric, Plaintiffs allege that LJM2 agreed to hold an interest in a power plant in Poland until Enron could find a permanent buyer for the asset. This, in itself, is neither fraudulent nor remarkable. Plaintiffs go on to allege that LJM2 paid $30 million for the interest that Enron wanted to sell. They do not allege that this money was not paid to Enron.

Plaintiffs then observe that, "The credit agreement governing the debt financing of the plant [however] required Enron to hold at least 47.5% of the equity in the project until completion. Enron was able to obtain a waiver of that requirement, but only through March 31, 2000. Thus, on March 29, 2000, Enron bought out LJM2s interest for a total of $31.9 million." NCC at ¶ 471. In essence, then, Plaintiffs allege that Enron sold LJM2 75% of an asset that was subject to a restrictive financing covenant. Enron obtained a limited waiver of that covenant to permit it to locate a buyer for the remaining interest. The waiver expired before Enron could locate a buyer. In order to avoid a covenant default, Enron repurchased the piece of the asset it had sold to LJM2. Plaintiffs do not suggest that when Enron sold this asset to LJM2, it did so intending to repurchase it three months later. Nor do Plaintiffs suggest that any individual Defendant believed, when this transaction was executed, that it was fraudulent or that Enron was not genuinely intending to locate a buyer for the plant. To the contrary, Plaintiffs allege that "[w]hen this transaction closed, it was clear this would be only a temporary solution" while Enron endeavored to locate a buyer for the remainder of the asset. *Id.* That Enron ultimately failed to find a buyer does not render the transaction fraudulent *ab initio*. In the absence of a specific pleading of why and how this transaction was known by some individual Defendant to be fraudulent at the time it as executed, this allegation does not state a claim of fraud.[29] *Williams*, 117 F.3d at 183.

D. MEGS

MEGS, according to Plaintiffs, involved a failed effort by Enron to sell an allegedly underperforming gas gathering asset. NCC at ¶ 472. Plaintiffs acknowledge that Enron entered

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[29] In fact, the only identifiable misrepresentation in this paragraph is the result of Plaintiffs' own "creative work." Plaintiffs allege that Enron bought LJM2's interest in the plant for a total of 31.9 million—a return Plaintiffs allege is "approximately a 25% rate of return." In fact, a return of $1.9 million on a $30 million investment is a 6.3% return. Plaintiffs apparently reach a "25% rate of return" by annualizing the rate of return for a non-recurring transaction.

into this transaction with LJM2 in good faith. "The parties expected to find a permanent buyer within 90 days." *Id.* When that effort did not succeed, Enron later repurchased LJM2's interests. One year later, Enron "recorded impairment on the gas wells due to diminished performance." *Id.*

Plaintiffs allege the total value of the MEGS transaction was a little over $26 million. *Id.* Plaintiffs do not, however, allege that a transaction of this size was material to Enron. *Id.* Although Plaintiffs allege that MEGS was "impaired," they do not allege by how much or whether the amount of the impairment was material to Enron. Presumably, since Plaintiffs allege this was impairment rather than a complete write-off, only some portion of the $26 million MEGS value was actually at issue even as Plaintiffs describe the transaction. Having failed to explain how a $26 million transaction was material to Enron, Plaintiffs are at an even greater loss to explain why a partial impairment of a $26 million asset was material to a prospective investor in Enron securities.[30]

Plaintiffs also fail to explain where this transaction should have been disclosed, why what was said (if anything) about it was misleading, how potential investors in a $60 billion company could have been misled by the alleged failure to disclose the partial impairment of a $26 million asset or who knew of this allegedly fraudulent transaction.[31] Plaintiffs have, therefore, failed to

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[30] A total impairment of this asset would have constituted less than .1% of Enron's capitalization—and is not a number that a reasonable investor would consider to have altered "the total mix of information" about a prospective investment in Enron.

[31] Plaintiffs make passing reference in this claim to a note by Jeff McMahon, then Enron's Treasurer. Although Plaintiffs attach a sinister connotation to it, the note clearly states that Mr. McMahon's group lacked sufficient data to opine on whether Enron would ultimately be able to market or sell the MEGS asset. It is not fraudulent to admit that one does not know something when, in fact, one does not know.

plead the required "who, what when and how" regarding this transaction. *Williams,* 117 F.2d at 183.

E. YOSEMITE

Plaintiffs' claim regarding Yosemite suffers from the same defects as their claim regarding MEGS. Plaintiffs contend that Enron entered into the Yosemite transaction with LJM2 "to allow Enron to avoid reporting its interest in Yosemite in its year-end financial statements." NCC at ¶ 474. Although Plaintiffs plead this claim in a convoluted fashion, the facts they allege are as follows:

1. Enron bought half of the Yosemite certificates for $37.5 million; this equates to a total value for the Yosemite Trust of $75 million. NCC at ¶ 474.

2. Enron wanted to reduce its ownership from 50% to 10% "in order to avoid disclosing its ownership of the certificates in its 'unconsolidated equity affiliates' note." *Id.* A 10% interest, on Plaintiffs' pleadings, would have been equal to $7.5 million. *Id.* A 40% interest, on Plaintiffs' pleadings, would have been equal to $30 million.

3. Enron, through a series of transactions, sold 40% of the Yosemite certificates to LJM2 for $35 million.

4. In other words, Enron made a $5 million profit on this transaction and, as a result of the sale, did not report on its year end financials its remaining, 10% interest in Yosemite.

Plaintiffs do not contend that it would have been improper for Enron to exclude a 10% equity interest from its "unconsolidated equity affiliates" note. *Id.* Moreover, Plaintiffs concede that Enron received $35 million cash for its sale of this asset to LJM2. *Id.* Plaintiffs' Complaint devolves, then, to two points: (a) this was a complicated transaction; and (b) although reported in 1999 it was not completed until 2000. Even assuming those allegations are true, Plaintiffs nonetheless fail to explain: (a) how even a 50% interest in Yosemite could have been material to a prospective investor in Enron; (b) why the timing of the transaction—which Plaintiffs concede actually occurred—was materially misleading to any potential investor; (c) what, if anything, any individual Defendant had to do with this transaction; or (d) how a transaction of this size could possibly have caused Enron's published financial statements to materially misstate the financial condition of Enron and its consolidated subsidiaries taken as a whole. That a transaction is complex does not mean it is fraudulent—and complexity is all that Plaintiffs have alleged as it pertains to Yosemite.

F. BACKBONE

Plaintiffs' claim with regard to Backbone is that LJM2 purchased dark fiber from Enron for $54 million and Fastow "was angry that [Enron] proposed to sell LJM2 dark fiber that was not usable." NCC at ¶ 475. Plaintiffs do not suggest that LJM2 never paid for the dark fiber; to the contrary, Plaintiffs allege that "the transaction was consummated and Enron recognized $54 million from it." *Id.* In essence, Plaintiffs allege that Enron got $54 million from LJM2 for an asset that was unusable. They do not allege this transaction was fraudulent; rather, they allege only that the transaction was a bad deal for LJM2. While that may have been injurious to LJM2's investors, Plaintiffs do not explain—anywhere—how this transaction was injurious or misleading to prospective investors in Enron. Plaintiffs do not allege any fraud at all regarding the Backbone transaction.

7. PLAINTIFFS' ALLEGATIONS DO NOT SUPPORT FRAUD RELATED TO THE RAPTOR TRANSACTIONS.

A. PLAINTIFFS MISSTATE THE DISCLOSURES RELATED TO THE RAPTOR STRUCTURES.

Plaintiffs make numerous references to the Raptors, but generally misstate what was involved in and disclosed about the Raptor transactions. The Raptors were formed to hedge Enron's positions in volatile merchant investments with a deconsolidated third party which was capitalized using Enron stock and third party cash. Three of the Raptors were capitalized with Enron stock; in Raptor III the equity supporting the hedge was New Power warrants.[32] Plaintiffs concede that these structures were complex. The determination of how to account for them required extensive interpretation of GAAP. While Enron suffered losses on the merchant investments that were hedged in the Raptor structures, Enron regularly informed investors of the existence of these losses in its related party disclosures. *See* SEC App. Tab 15, at 96 (noting that hedge income from the Raptor structures "offset changes in the market value of certain merchant investments"). Eventually, the Raptor hedges were unwound when they failed, but the fact that they did not work does not mean they were fraudulent.

Failure is not fraud—no matter how spectacular the failure may be. "Securities fraud cases often involve some more or less catastrophic event occurring between the time the complained of statement was made and the time a more sobering truth is revealed (precipitating a drop in stock price).... When such an event has occurred, it is clearly insufficient for plaintiffs to say that the later, sobering revelations make the earlier, cheerier statement a falsehood." *In re Glenfed*, 42 F.3d at 1549. In the words of the Fifth Circuit, "[a]ll investment carries risk. A loss,

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[32] A fourth structure, Raptor IV, was never utilized.

standing alone, does not give rise to a claim under the federal securities laws." *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1450 (5^{th} Cir. 1993). Plaintiffs also do not identify any GAAP provision that prohibited the accounting treatment selected by Enron. Of equal importance, Plaintiffs repeatedly allege that Enron relied heavily on Andersen and its outside attorneys to assist it in structuring these transactions. NCC at ¶ 801, 897.

While the Plaintiffs mention the Raptor structures many times throughout their Complaints, the core of their allegations are found in the *Newby* Complaint at paragraphs 477 through 495 and in the *Tittle* Complaint at paragraphs 327 through 349.

i. Raptor I

Plaintiffs allege that Raptor I (a/k/a "Talon LCC") "was created solely to engage in hedging transactions with Enron." NCC at ¶ 477. Plaintiffs claim that LJM2, as manager of Talon, invested $30 million in cash and received a membership interest. Plaintiffs then claim that the $30 million of capital invested by LJM2 was not really "at risk" and, thus did not meet the 3% outside equity requirement for non-consolidation. NCC at ¶ 478. Thus, Plaintiffs conclude, "LJM2 did not qualify for non-consolidation but was not consolidated in violation of GAAP." *Id.* Additionally, according to Plaintiffs, Enron was required by GAAP to record a charge against income based on Talon's credit deficiency and entered into a costless collar to avoid recognition of a loss. NCC at ¶ 481.

ii. Raptors II and IV

In a three paragraph treatment of these two Raptors, Plaintiffs allege that these "Raptors were intended to, but did not; engage in valid derivative transactions with Enron." NCC at ¶¶ 482-84. Plaintiffs allege nothing more specific than that.

iii. Raptor III

Plaintiffs allege that Raptor III:

> was intended to hedge a single large Enron investment in The New Power Company ("New Power"), later named New Power Holdings. Instead of holding Enron stock, Raptor III held the stock (or warrants) of the very company whose stock it was intended to hedge – New Power. If the value of New Power stock decreased, the vehicle's obligation to Enron on the hedge would increase in direct proportion. At the same time, its ability to pay Enron would decrease. Raptor III was thus the derivatives equivalent of doubling-down on a bet on New Power.

NCC at ¶ 485. Plaintiffs go on to allege that Enron entered into a hedging transaction with the Raptor III SPE, ultimately allowing Enron to "improperly" record an accounting gain of $370 million in the 4th quarter of 2000. NCC at ¶ 488.

B. PLAINTIFFS' PLEADINGS FAIL TO CONSIDER ENRON'S DETAILED DISCLOSURES CONCERNING THESE TRANSACTIONS.

Plaintiffs' pleadings regarding the Raptor structures do nothing more than charge Enron with improper accounting. Plaintiffs do not, however, cite a single accounting rule that was supposedly violated (other than EITF No. 85-1 (App. Tab 61) related to the Raptor restructuring which occurred months *after* the Raptor transactions were first disclosed).

Plaintiffs allege no facts to support an inference that any Defendant believed the Raptor accounting treatment was in error when the transactions were booked. Importantly, as to Raptors II and IV, Plaintiffs state that these "Raptors were *intended to*, but did not engage in valid derivative transactions with Enron." NCC at ¶ 482. These are not allegations of fraudulent accounting; they are allegations that Enron intended proper accounting and erred. Accounting mistakes do not support an inference of fraud. *Wells v. Monarch Capital Corp.* , 1996 WL 728125 (D. Mass. Oct. 22, 1996), *aff'd* 129 F.3d 1253 (1st Cir. 1997).

In addition, Plaintiffs do not state how any of the Defendants were involved in the Raptor formation and accounting. Other than alleging that Causey and Fastow signed certain documents, (NCC at ¶ 480) and that Skilling allegedly told employees that "fixing the Raptors' credit capacity problem was one of the Company's highest priorities," no individual Defendant is even mentioned in the Raptor allegations. Even for those Defendants who are mentioned, none is accused of fraud; and there are no allegations of when, where, what, why, how or whether they knew anything related to the alleged accounting improprieties.[33] "It is absurd, in these circumstances, for plaintiffs to suggest that . . . defendants, who are not accountants, possibly could have known of any mistakes by [the accountants]." *In re Worlds of Wonder*, 814 F. Supp. at 864-65. Since Plaintiffs have not pled the most basic, required elements, these transactions cannot form the basis of a valid fraud claim.

Plaintiffs' allegations regarding the Raptor structures fail to state a claim for the following additional reasons. First, with respect to Raptor I, Raptor II, and Raptor IV, Plaintiffs provide no specifics to substantiate their allegation that "LJM2 did not qualify for non-consolidation." NCC at ¶ 478. In fact, the statement itself reveals the inadequacy of Plaintiffs' allegations. LJM2 was a separate entity in which Enron had no financial interest or voting control. Additionally, it was not an SPE which Enron sponsored. Therefore, non-consolidation of LJM2 was not an issue. What Plaintiffs probably intend, but do not allege, is that the Raptor

[33]Plaintiffs have nowhere pled that Enron knew the Raptor hedges would fail at any time before they actually failed. Plaintiffs have also failed to plead with specificity that any Defendant knew the related party disclosures made by Enron were inaccurate when they were made. In the absence of a specific pleading of facts establishing that: (a) any Defendant knew Enron's disclosures were inaccurate when made, (b) how they were inaccurate, (c) why what was allegedly omitted was material, or (d) what Enron actually said about these transactions that was incorrect or misleading, Plaintiffs have failed to state a claim for relief. Their Complaints concerning the Raptor transactions must also be dismissed.

SPE's Talon (Raptor I), Timberwolf (Raptor II), and Bobcat (Raptor IV) should have been consolidated into Enron's balance sheet. Even if that were Plaintiffs' complaint, it would be wrong. LJM2's original 3% investment in each of the three SPEs remained at risk the entire time of the transaction. Distributions of income to partners from an SPE can be made to the extent of income earned (so that the original 3% risk is not eroded). EITF No. 96-21, Question No. 5. Accordingly, the $41 million distribution to LJM2 did not erode LJM2's 3% investment because Talon had recognized at least that amount of income from a put that Enron had purchased from Talon for $41 million. As a result of Enron's stock continuing to rise, the put had little or no value to Enron, which left Talon with the $41 million in income to distribute without touching the original $30 million invested by LJM2. Thus, the original $30 million remained at risk, and LJM2 had a continuing financial stake in Talon. Like Talon, Timberwolf also recognized income and distributed income, not equity, to LJM2.[34]

Second, Plaintiffs' complaint that Enron entered into a costless collar "only" to "avoid recognition of a loss" is strange. NCC at ¶¶ 481, 484. It is a proper and expected business practice to try to avoid losses. Plaintiffs do not state that the costless collar was inappropriate or that it violated any accounting rules. Instead, Plaintiffs' complaint is that the costless collars ultimately did not fix the credit capacity problem of the Raptor. Failure, however, is not the same as fraud. Moreover, the costless collar arrangements on the Enron stock were disclosed in note 8 to the March 31, 2001 10-Q.

Third, Plaintiffs' claim that Enron "improperly" recorded a $370 million gain due to the Raptor III hedge misunderstands the accounting issues. Enron owned a position in New Power.

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[34]Bobcat (Raptor IV) was never utilized.

At the time of the New Power IPO, the New Power stock went up, creating a gain over Enron's basis in the stock regardless of the Raptor structure being created. *See* SAB 51. A second component of the $370 million gain resulted from Enron's sale of New Power warrants to Hawaii that were subject to SFAS 125 and SFAS 140. The SAB 51 gain was disclosed on Enron's income statement and in items affecting comparability in the EES management discussions in the quarterly reports. The SFAS 125 and 140 gain is disclosed in note 3 of the 2000 Annual Report under "Securitizations" and as an item impacting operating income in the EES management discussion. These gains would have been required to be recognized whether or not the Raptor hedge was in effect.

Plaintiffs also object that the pre-IPO New Power securities contributed to Raptor III were valued at $10.75 per share, when the company went public at $21.00 per share. NCC at ¶¶ 485-88. They fail to state, however, that the last private equity financing of New Power three months earlier had resulted in a per share value of $10.75. In comparison to this certain and recent valuation, which was publicly disclosed in the New Power registration and offering documents, Enron had no assurance that the IPO would be successful. Indeed, the market for concept stocks decreased dramatically one week following the New Power IPO. And, although New Power debuted at a high price and Enron was optimistic, New Power's stock slid, hovering in the $5-$10 range for many months.

The Plaintiffs suggest that the founding and spin off of New Power was a sham to allow Enron to book paper profits on essentially worthless stock. Their own allegations, however, belie this theory. "New Power was a bona fide business designed to market electric power to retail customers." NCC at ¶ 487; TCC at ¶ 350, 357. It had real customers, although evidently not as many as it needed. TCC at ¶ 362. It ran into trouble when much of its potential market was eliminated by unforeseen developments that delayed the deregulation on which its business plan depended. TCC ¶ at 363. The difficulties that caused its stock price to fall are not alleged to have anything to do with the events underlying Plaintiffs' claims. TCC at ¶¶ 363-64.

Fourth, in paragraph 491, addressing the restructuring of Raptors, Plaintiffs further belabor over the credit difficulties encountered by the various Raptors.

> The restructuring transaction, which was made effective as of 3/26/01, consisted of two principal parts: a cross-collateralization of the Raptors and an additional infusion of Enron stock contracts. The restructuring allowed Enron to record only a $36.6 million credit reserve loss for the 1st Q 01, rather than the $504 million loss Enron was required to record pursuant to GAAP.

NCC at ¶ 491. As they do repeatedly throughout the Complaints, however, Plaintiffs ignore the disclosures made in the notes of the financial statements. Enron disclosed its accounting treatment of the restructuring in note 8 of the March 31, 2001 10-Q:

> Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of these transactions, Enron has entered into agreements with entities formed in 2000 (the Entities), which included the obligation to deliver 12 million shares of Enron common stock in March 2005 (the Commitment) and entered into derivative instruments which eliminate the contingent nature of existing restricted forward contracts executed in 2000. The Commitment and the shares to be delivered under the derivative instruments are restricted through March 2005. In exchange, Enron received note receivables from the Entities totaling approximately $827.6 million. In addition, Enron entered into share settled costless collar arrangements with the Entities on the 12 million shares of Enron common stock. Such transactions will be accounted for as equity transactions when settled. Enron received a $6.5 million note receivable from the Entities to terminate share-settled options on 7.1 million shares of Enron common stock. The transactions resulted in non-cash increases to non-current assets and equity.

SEC App., Tab 17, at 15. Other than EITF No. 85-1 regarding the classification of the notes receivable received for stock which is addressed in Section IV.C., *infra*, Plaintiffs do not cite any offended GAAP principle. Even if they did, however, the accounting treatment and income issues were fully disclosed to investors in the Annual Reports and the notes to the Financial Statements. Fraud cannot be based on allegations of "hidden" information that was in fact disclosed, and fraud cannot be stated based on allegedly improper accounting treatment when Enron's accounting treatments were revealed to investors.

Plaintiffs do not suggest, however, that Enron knew those problems would exist when it entered into the Raptor hedges. Having failed to allege with specificity when Enron knew that the credit problems of the Raptors were unsolvable, *Williams* 112 F.2d at 178 ("Directly put, the who, what, when and where must be laid out"), Plaintiffs have failed to plead any claim of fraud with regard to the Raptors. Certainly, having failed even to mention the individual Defendants in this regard renders Plaintiffs' claims insufficient.

Finally, to the extent Plaintiffs contend that the related party hedges in the Raptor structures were "unreasonable" because the Raptors ultimately had credit problems; they do nothing other than to plead a claim of mismanagement or "fraud by hindsight." The Supreme Court held a quarter century ago that allegations of mismanagement do not state a claim for securities fraud. *Santa Fe Indus.*, 430 U.S. 462. The Third Circuit has likewise rejected the invitation to find that "the failure to disclose [a] breach of fiduciary duty is a misrepresentation sufficient to constitute a violation" of the securities laws. *Biesenbach v. Guenther*, 588 F.2d 400, 402 (3d Cir. 1978).

In sum, Plaintiffs do not plead that any Defendant knew, at the time Enron entered into these transactions, that the Raptor structures were not reasonably able to meet the credit obligations represented by these hedges. Moreover, any "erroneous" accounting treatment was fully disclosed. That these structures subsequently experienced credit difficulties was nothing more than a fully disclosed counterparty credit risk that came to fruition. *See* SEC App, Tabs 15 at 52-53; 15 at 85-88, 95-96 ("derivatives are pegged at $67 per share"). Counterparty credit problems, and their potential significance to Enron, were the subject of an express cautionary disclosure by Enron. These disclosures "directly address[ed] the substance of the statements the Plaintiffs challenge," *Parnes*, 122 F.3d at 548, regarding the Raptor structures. That Plaintiffs ignore what Enron disclosed does not mean Enron failed to disclose it—nor does it render material statements that were made immaterial by Enron's meaningful cautionary disclosures about the risks of its hedging and derivative transactions. *See In re Waste Management,* at 85-86 n.27.

D. PLAINTIFFS' ALLEGATIONS REGARDING MAHONIA, DELTA AND CONNECTICUT RESOURCES DO NOT PLEAD A CLAIM.

Plaintiffs next allege that the Enron Defendants disguised loans to the Company as hedging or derivative transactions with Mahonia, Delta and Connecticut Resources. Once again, Plaintiffs fail to properly plead a GAAP violation or to plead any facts detailing which of the individual Defendants were involved in the alleged fraud. Instead, Plaintiffs merely conclude that the transactions were loans because they do not have all the elements the Plaintiffs contend constitute a true forward contract. However, the Defendants properly accounted for the transactions and they were adequately disclosed.

In each of these transactions, Enron received a fixed amount of cash in return for a floating payment in cash or a commodity, the amount determined as the product of future commodity index prices and fixed commodity volumes. Because the volumes to be repaid by Enron are fixed, but the commodity prices fluctuated, Enron was providing a price risk management service. The existence of the price risk distinguishes the transaction from a loan. In fact, the Plaintiffs admit that the transactions with CitiGroup were derivative trades known as prepaid swaps. NCC at ¶ 566; TCC at ¶ 644.

The accounting effect of these transactions was also disclosed. When Enron received the fixed amount of cash for the derivative trade, it recorded cash on the balance sheet and a corresponding liability, disclosed on the balance sheet on an aggregated basis with other contracts as "Liabilities from price risk management activities." See Note 1 "Accounting for Price Risk Management Activities." Additionally, each year, the financial statements contained notes regarding Enron's price risk management activities. *See, e.g.,* notes 1 and 3, 2000 Annual Report. Thus, once again, the allegedly "hidden debt" was disclosed. Plaintiffs do not allege that Enron violated GAAP with respect to the Mahonia, Delta and Connecticut Resources transactions.

E. PLAINTIFFS HAVE FAILED TO DEMONSTRATE THAT ENRON'S USE OF MARK-TO-MARKET ACCOUNTING PRACTICES WAS IMPROPER OR MISLEADING.

Mark-to-market accounting ("MTM") is an appropriate and, in fact, now mandated, method of accounting used by Enron for valuing certain assets, including energy trading contracts. Yet, Plaintiffs take issue with this method of accounting, claiming that its use is tantamount to fraud. In their Complaints, Plaintiffs allege generally that the "Enron Defendants" collectively and intentionally used MTM accounting to commit fraud. NCC at ¶ 18, 36, 38, 40, 41, 70(a), 70(e), 121(g), 155(e), 155(f), 214(e), 340, 422, 426, 520, 525, 533-539, 540, 542, 543, 544, 727, 890, 959. They also claim that through the "misuse" and "abuse" of MTM accounting Enron was able to improperly and prematurely accelerate revenue recognition, increase its revenues, and overstate the value of various holdings.[35] As discussed below, there are no facts in Plaintiffs' Complaints demonstrating that allegations relating to MTM constitute anything more than Plaintiffs' "belief," unsupported by reference to any principle of GAAP, that this accounting method was abused by Defendants.

1. ENRON'S STATEMENTS CONCERNING ITS USE OF MTM ACCOUNTING WERE NEITHER FALSE NOR MISLEADING.

A. ENRON'S USE OF MTM ACCOUNTING WAS NOT ONLY PERMISSIBLE, BUT MANDATED.

Plaintiffs use the term "mark-to-market" accounting as if mere proof that Enron employed MTM accounting is evidence of fraud. To the contrary, MTM accounting is in fact, a legitimate and acceptable accounting method. It accurately depicts the relative import of certain financial activities. To wipe clean the conclusory and unsubstantiated taint that Plaintiffs have attempted to instill upon the practice of "marking" assets, contracts, and investments "to market," it is necessary to briefly explain the well-recognized underlying justifications and authority for that practice.

Energy trading contracts[36] typically have no net up-front cost because they create rights and obligations that are initially equal, but opposite – *i.e.*, they are zero-sum. Such contracts

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[35]*See* NCC at ¶¶ 18, 36, 121(e), 155(e), 214(e), 300(e), 339(e), 418, 426, 533, 537, 549, 651(c), 935. Plaintiffs also make numerous other allegations with respect to supposed abuses of MTM accounting, but do so as an inseparable component of broader allegations of fraud within Enron's WEOS, EES and Broadband divisions, and with respect to related party transactions. As such, to the extent those additional allegations relating to mark-to-market accounting are not addressed here, they are confronted within those other sections.

[36]Controlling accounting standards define energy "contracts" in this context as "contracts entered into for (or indexed to) the purchase or sale of electricity, natural gas, natural gas liquids, crude oil, refined products, coal, and other hydrocarbons (collectively, energy). Energy trading contracts also include energy-related contracts (*e.g.*, capacity contracts, requirements contracts, and transportation contracts). Energy trading activities or energy trading contracts refers to

therefore escape recognition in a cost-based accounting model unless and until the contracts are transferred or closed.[37] By contrast, under MTM accounting, contracts are recorded as trading activities, with their value adjusted to reflect changes, whether higher or lower, in the market prices of the underlying commodity at each financial reporting date, even though an actual transaction pursuant to the contract has not yet occurred.[38] MTM accounting is, as a result, especially important in providing relevant and transparent information about energy trading derivatives and contracts because the alternative, cost-based methods, may fail to account for them at all during the period they are outstanding.[39]

Prior to the issuance of EITF No.[40] 98-10 (effective January 1, 1999), energy traders, including Enron, routinely accounted for their energy trading contracts through MTM valuations. Effective January 1, 1999, Issue 98-10 of the FASB's Emerging Issues Task Force ***required*** that energy trading contracts be accounted for on a MTM basis, recognizing gains ***or losses***

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energy trading contracts entered into with the objective of generating profits on or from exposure to shifts or changes in market prices ... trading activities also include dealing (the activity of standing ready to trade – either buying or selling – for the dealer's own account, thereby providing liquidity to the market). EITF No. 98-10, at ¶ 2.

[37]*See, e.g.,* Testimony of Edmund L. Jenkins, Chairman FASB, Before the Subcommittee on Commerce, Trade and Consumer Protection of the Committee of Energy and Commerce, February 14, 2002. App. Tab 40, at 10.

[38]*Id.*

[39]*Id.*

[40]The FASB established the EITF in July 1984 to assist the FASB in the early identification of emerging issues affecting financial reporting and of problems in implementing authoritative pronouncements. The SEC's Chief Accountant has said that he would challenge any accounting that differs from a consensus of the Task Force. The application of EITF consensuses is mandatory under SAS 69.

concurrent with market fluctuations.[41] Plaintiffs repeatedly imply that Enron's use of this mandatory method of valuation and recognition was nothing less than sleight-of-hand accounting "tricks,"[42] and never address the fact that MTM accounting was both appropriate and required. Assertions that following requirements under applicable accounting pronouncements is fraudulent or misleading cannot give rise to liability against a corporation which complied with the pronouncement and disclosed that fact. Plaintiffs' failure to even mention the legitimacy of MTM accounting demonstrates the disingenuous, if not deceptive, nature of their pleading.

B. ENRON'S MTM ACCOUNTING PRACTICES WERE REPEATEDLY AND ACCURATELY DISCLOSED, AS WERE ITS INHERENT VARIABLES AND RISKS.

Plaintiffs allege that Enron made false and misleading disclosures regarding the financial results of its businesses through supposed abuses of MTM accounting. NCC at ¶ 36; TCC at ¶¶ 303, 372. Notably, Plaintiffs ignore the fact that Enron's public filings, both before and during the class period not only disclosed Enron's use of MTM accounting, but fully explained the

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[41] EITF No. 98-10: Accounting for Contracts Involved in Energy Trading and Risk Management Activities

> At the November 18-19, 1998 meeting, the Task Force ... reached a consensus that energy trading contracts should be marked to market (that is, measured at fair value determined as of the balance sheet date) with the gains and losses included in earnings and separately disclosed in the financial statements or notes thereto. The SEC Observer stated that ... when an operation enters into complex written options or written options in which the operation does not stand ready to deliver energy, such contracts should be marked to market with gains and losses shown net in the income statement, regardless of whether the operation is considered to be involved in trading activities. The SEC Observer also stated that an operation does not stand ready to deliver energy pursuant to a written option if the written option requires net cash settlement or the writer of the option has a past practice of settling written options in cash.

[42] *See* NCC at ¶18.

effect of that accounting on Enron's reported financial results and the inherent assumptions, variables and risks associated with that accounting model. These disclosures rebut Plaintiffs' fraud allegations with respect to MTM accounting.

i. Enron's Public Filings Repeatedly and Accurately Disclosed and Explained Its Use of MTM Accounting for Its Risk Management Activities.

Despite implications in the Complaints, Enron disclosed its use of MTM accounting. Recognizing that MTM would provide greater transparency to the public by displaying a more accurate picture of the period-to-period loss or gain on merchantable assets or investments, Enron adopted this accounting method in the early 1990's, well before EITF No. 98-10 *required* its use for risk management activities. In 1991, Enron disclosed that it had adopted MTM "for its energy-related price risk management operations." Since that time, and particularly during the Class Period, Enron has fully disclosed its use of MTM, and has further explained the implication of that accounting method.

In each of Enron's Financial Statements, as filed in Enron's Annual 10-K, for the years covering 1997 through 2000, Enron disclosed its use of MTM and how market values would be used to obtain current period gains or losses on financial instruments:

> Accounting for Price Risk Management. Enron engages in price risk management activities for both trading and non-trading purposes. Financial instruments utilized in connection with trading activities are accounted for using the mark-to-market method. Under the mark-to-market method of accounting, forwards, swaps, options and other financial instruments with third parties are reflected at market value, net of future servicing costs, with resulting unrealized gains and losses recorded as "Assets and Liabilities From Price Risk Management Activities" in the Consolidated Balance Sheet. ... Current period changes in the assets and liabilities from price risk management activities (resulting primarily from newly

> originated transactions, restructuring and the impact of price movements) are recognized as net gains or losses in "Other Revenues." ...[43]

Additionally, Enron's annual financial statements disclosed that "[t]he merchant investments made by Enron" were "carried at fair value" – that is, valued at market value.[44]

Finally, in each of Enron's quarterly 10-Qs from the 1st Quarter 1998 through the 2nd Quarter 2001, Enron further disclosed its use of MTM and its consequences by explaining to investors that earnings from energy-related financing and investing were derived from changes in market value. For example, Enron disclosed:

- The results of this [finance and investing] business include earnings from changes in the composition and market value of these investments.[45]

- Earnings from these [energy-related] investments primarily result from changes in the market value of merchant banking related investments held during the period, equity earnings and gains on sales or restructurings of other investments.[46]

- Earnings from merchant investments were favorably impacted by a significant increase in the market value of Enron Wholesale's power-related investments, partially offset by the decline in value of investments in certain energy-intensive industries. ... Earnings from these activities result from changes in the market value of the securities.[47]

In these public filings, Enron fully disclosed that it used MTM to value its financial and risk management activities and that the basis of such accounting was fair market value. To the

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[43]SEC App. Tabs 1 at 70-71; 6 at 85; 10 at 73; 15 at 68 .

[44]SEC App., Tab 2 at 76-77; 15 at 76.

[45]SEC App. Tab 3, at 19.

[46]SEC App., Tab 4 at 21-22; *see also* SEC App. Tab 5, at 19.

[47]SEC App. Tab 14 at 21-22. *See also* SEC App. Tabs 7 at 20; 8 at 22; 9 at 21-22; 12 at 21; 13 at 21-22; 17 at 22; 18 at 21.

extent Plaintiffs premise their fraud claims on the use of MTM, or the failure to adequately explain its use to investors, they must fail. *See Atkins v. Hibernia Corp.*, 182 F.3d 320, 326 (5th Cir. 1999) (where a public document fully discloses information material to the allegedly concealed matter, dismissal is appropriate under Rule 12(b)(6)).

ii. Enron's Public Filings Disclosed the Risks Inherent in MTM Accounting.

In addition to the disclosures set forth above, throughout the time relevant to the purported class Enron's public filings disclosed the variables and risks of the use of MTM accounting. Enron warned that financial results from activities accounted for using MTM were dependent upon the judgment and/or valuation of investments or assets of Enron's management:

- The market prices used to value these transactions reflect management's best estimate considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments.[48]

- Judgment is necessarily required in interpreting market data and the use of different market assumptions or estimation methodologies may affect the estimated fair value amounts.[49]

- From time to time, Enron sells interests in these merchant assets and investments. Some of these sales are completed in securitizations, in which Enron retains certain interests through swaps associated with the underlying assets. Such swaps are adjusted to fair value using quoted market prices, if available, or estimated fair value based on management's best estimate of the present value of future cash flow.[50]

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[48]SEC App. Tabs 2, at 78; 6, at 85; 10, at 73; 15, at 68.

[49]SEC App., Tabs 2, at 85; 6, at 93; 10, at 80-81; 15, at 75. Under MTM accounting, contracts are recorded as trading activities, with their value adjusted to reflect changes, both higher and lower, in the market prices of the underlying commodity at each financial reporting date. 02/01.

[50]SEC App. Tab 10 at 82; *see also* SEC App. Tab 15, at 73.

In addition, Enron made clear that Enron's financial services business was a risk-intensive venture whose success was dependent on numerous, disclosed market conditions and risks, as well as Enron's ability to successfully hedge against those variables.

- Earnings from Enron Wholesale are dependent on the origination and completion of transactions, some of which are individually significant and which are impacted by market conditions, the regulatory environment and customer relationships. ... External factors, such as the amount of volatility in market prices, impact the earnings opportunity associated with Enron Wholesale's business. Risk related to these activities is managed using naturally offsetting transactions and hedge transactions. The effectiveness of Enron's risk management activities can have a material impact on future earnings.[51]

- Market Risk. The use of financial instruments by Enron's businesses may expose Enron to market and credit risks resulting from adverse changes in commodity and equity prices, interest rates and foreign exchange rates. [Specific risks include] "Commodity Price Risk ... Interest Rate Risk ... Foreign Currency Exchange Rate Risk ... [and] Equity Risk."[52]

- The effectiveness of Enron's risk management activities can have a material impact on future earnings.[53]

- Management of the market risk associated with its portfolio of transactions is critical to the success of Enron.[54]

- The ability of Enron to meet stated projections depended on "the effectiveness on Enron's risk management activities."

Finally, Enron disclosed that Enron's success at managing these risks depended upon, among other variables management's estimations, assumptions and judgment.

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[51]SEC App. Tab 6, at 53; *see also* SEC App. Tabs 2, at 55; 10, at 47; 15, at 41-42

[52]SEC App. Tabs 2 at 60-61; 6, at 67-68; 10, at 54; 15, at 50.

[53]SEC App. Tabs 6, at 53; 10, at 47; 15, at 42.

[54] SEC App. Tab 6, at 67.

- The quantification of market risk using value at risk provides a consistent measure of risk across diverse energy markets and products. The use of these methodologies requires a number of key assumptions including the selection of a confidence level for expected losses, the holding period for liquidation and the treatment of risks outside the value at risk methodologies, including liquidity risk and event risk. Value at risk represents an estimate of reasonably possible net losses in earnings that would be recognized on its portfolios assuming hypothetical movements in future market rates and is not necessarily indicative of actual results which may occur.[55]

- Because of the inherent limitations to value at risk, including the use of delta/gamma approximations to value options, subjectivity in the choice of liquidation period and reliance on historical data to calibrate the models, Enron relies on value at risk as only one component in its risk control process. In addition to using value at risk measures, Enron performs regular stress and scenario analyses to estimate the economic impact of sudden market moves on the value of its portfolios. The results of the stress testing, along with the professional judgment of experienced business and risk managers, are used to supplement the value at risk methodology and capture additional market-related risks, including volatility, liquidity and event, concentration and correlation risks.[56]

These filings make clear that Enron exhaustively disclosed that the use of MTM entails particular risks and required management to enter into other financial arrangements, based upon their best judgments and estimations, to protect against volatility inherent with MTM. Plaintiffs assert their "belief," without factual basis, that Enron's MTM accounting was somehow fraudulent. However, Enron's filings and public disclosures made clear to all investors that, by definition, MTM involved the use of informed estimates as to future and current values. Having

[55] SEC App., Tab 2, at 60; *see* SEC App. Tabs 6, at 68; 10, at 54-55.

[56]SEC App. Tab 6, at 69.

been provided this information, Plaintiffs' generalized allegations relating to MTM accounting must fail.[57]

In light of these disclosures, contained in the reports Plaintiffs alleged were false and misleading, it may not be surprising (although disingenuous) that Plaintiffs fail to even mention them. However, these disclosures demonstrate that Plaintiffs' claims with respect to MTM accounting are nothing more than unsupported conclusions, parsed from documents containing cautionary and explanatory language, and should be dismissed. *Lemmer v. Nu-Kote Holding, Inc.*, 2001 U.S. Dist. LEXIS 13978, *22 (N.D. Tex. 2001) ("It is not sufficient to simply allege certain facts that support a final conclusion, when those 'facts' themselves are conclusory; the PSLRA is satisfied only by facts, not conclusory allegations.").

2. PLAINTIFFS' ALLEGED MISREPRESENTATIONS RELATING TO ENRON'S GENERAL USE OF MTM ACCOUNTING PRACTICES ARE INSUFFICIENT TO SATISFY THE PLEADING REQUIREMENTS UNDER THE PSLRA AND RULE (B).

Throughout the Complaints, Plaintiffs make broad allegations relating to Enron's supposed abuse of MTM accounting, while making vague reference to certain general categories of assets whose values were allegedly misreported.[58] Additionally, Plaintiffs allege that Enron manipulated earnings over a somewhat more specific group of assets, however, fail to provide

[57] *See, e.g., Ply-Gem Industries, Inc. v. Green*, 503 F.2d 1362, 1365 (2d Cir.1974) (federal securities fraud claim and related pendent state claims were without merit where plaintiff had knowledge of all the facts alleged to be fraudulently not disclosed); *In re Advanta, Corp., Sec. Litig.*, 1998 WL 387595 (E.D. Pa. 1998) (dismissing securities law claims based on fraudulent disclosures where disclosures themselves fully and accurately revealed facts allegedly concealed); *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407 (9th Cir. 1994) (claims of securities fraud dismissed where prospectus adequately disclosed the risks of the bonds).

[58] NCC at ¶¶ 18, 36, 121(e), 4(e), 300(e), 200(e)(ii), 339(e), 339(e)(ii), 418(d), 423, and 416.

any greater details of the alleged manipulations.[59] Their general allegations are demonstrably insufficient as a matter of law. They have failed to plead particularized facts in support of their claims of abuse of MTM accounting. Moreover, Plaintiffs are unable to make any specific allegations demonstrating a strong inference of scienter as to Defendants with regard to Enron's improper use of MTM. The lack of specificity and particularity in those allegations therefore fail to meet Plaintiffs' pleading burden under the PSLRA and Rule 9(b).

A. THE GENERAL ALLEGATIONS FAIL DUE TO VAGUENESS.

Plaintiffs' general allegations of MTM accounting abuses fall into two broad categories. First, the majority broadly allege that Enron manipulated and falsified earnings by misusing MTM accounting. Specifically, the Complaints baldly characterize Enron's use of mark-to-market as improper, solely by branding it as such:

> Enron's reported profits were being generated by ...improper accounting tricks – including the misuse and abuse of 'mark-to-market' accounting techniques to accelerate the recognition of hundreds of millions of dollars of profits. NCC at ¶18.
>
> The results of Enron's wholesale (WEOS) business ... were manipulated and falsified ...by abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. NCC at ¶¶ 121(e), 214(e), 300(e), 339(e).
>
> In order to overstate Enron's assets, shareholders' equity, revenues, net income and earnings per share ... by grossly abusing mark-to-market accounting. NCC at ¶418(d).

Liberally construed, Plaintiffs apparently contend that Enron's financials were false and misleading because of improper use of MTM accounting to accelerate earnings and improve operating results. Yet, Plaintiffs do not even *attempt* to explain who was involved in this alleged

[59] This includes MTM allegations with respect to Merchant Assets, EES, Broadband, Arthur Andersen, Banks, and related party Transactions.

conduct, when it occurred, who had knowledge of it, and what, if any, impact it had on Enron's earnings. The mere conclusions that Enron did so are insufficient to satisfy the most basic pleading requirements of Rule 9(b) and the PSLRA.

Second, Plaintiffs allege that Enron's press releases, SEC filings, and other public statements were false because of its abuse and manipulation of MTM accounting.

> These representations [SEC filings, including Form 10-Qs for the interim results and Form 10-Ks for the annual results] were false and misleading as to the financial information reported, as such financial information was not prepared in conformity with GAAP, and was not "a fair presentation" of the Company's operations and financial position due to ... its abusive and manipulative use of mark-to-market accounting. NCC at ¶426(iii).

> In order to overstate Enron's assets...and present materially misleading financial statements...defendants caused the Company to violate GAAP and SEC rules, in several ways, including ... by grossly abusing mark-to-market accounting. NCC at ¶418(d).

These allegations fail for the same reasons as set forth above. Simply put, they lack particularity as to why the statements were false. The Complaints fail to specify *what statements* regarding MTM accounting, or what information based on MTM accounting, were false or misleading, and *why* those statements were false or misleading especially in light of disclosures of the use and risks associated with MTM accounting, detailed above. Notwithstanding the sheer number of times Plaintiffs trot out the terms "abuse," "misuse," "manipulation," or other like phrases, in describing mark-to-market accounting, they have put forth nothing more than vague and conclusory allegations of the supposed fraud as it relates to Enron's use of MTM.[60]

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[60]*See, e.g., Ruble v. Rural/Metro Corp.*, 2001 WL 1772319 *10 (D. Ariz. 2001):

> Plaintiffs have to plead the facts--the *who, what, when, where, why, and how* of their case--and the related documents so that they will tell a story (or paint a picture) from which the court can perceive that there is or is not a basis for a

B. ALL MTM ALLEGATIONS AS TO INDIVIDUAL DEFENDANTS FAIL DUE TO LACK OF SCIENTER.

In addition to the requirement of particularity, Plaintiffs are required to set forth specific facts which give rise to a strong inference that each Defendant acted with the requisite state of mind. 15 U.S.C. § 78u-4(b)(s). When a complaint fails to plead scienter in conformity with the PSLRA, dismissal is required. *Lemmer*, 2001 U.S. Dist. LEXIS 13978 at *15-16 (N.D. Tex. 2001). Plaintiffs have alleged no specific facts demonstrating that any Defendant acted with a reckless or conscious effort to defraud. Mere allegations that they wanted to keep the stock price up, or receive greater compensation are insufficient. *See Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 623 (4th Cir. 1999).

GAAP mandated use of MTM. Enron disclosed its use of MTM. In all, Plaintiffs state nothing more than conclusory allegations supporting their belief that Enron committed fraud by abusing or misusing MTM accounting. Plaintiffs' inability to specify and plead the particular

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> strong inference of deliberate recklessness on the part of Rural/Metro and those speaking for it. Section 78u-4(b)(1) gives the private securities case pleader a road map of what he must allege in his complaint. *He has to specify each statement alleged to be misleading. He must state the reason or reasons why the statement is misleading.* And where the allegation regarding the statement or omission is made on "information and belief" or the investigation of plaintiff's counsel, he must state with particularity all the facts on which that belief is formed. 15 U.S.C. § 78u-4(b)(1).

See also, In re BankAmerica Corp. Sec. Litig., 78 F.Supp. 2d 976, 987 (E.D. Mo. 1999) ("To satisfy this heightened pleading standard, plaintiffs must 'specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent.'") (quoting *Williams v. WMX Technologies, Inc.*, 112 F.3d 175, 177 (5th Cir.1997)); *In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309, 320-21 (8th Cir.1997) (requiring plaintiffs to demonstrate who made the allegedly fraudulent statement, when it was made, and why it is allegedly false and to plead specific facts showing how alleged fraudulent omissions were material).

facts and circumstances relevant to their broad-based allegations concerning MTM accounting, is thus fatal to their claim.

F. Plaintiffs' Allegations Regarding Enron's Accounting for Impairment Confuse the GAAP Rules and do not Raise Fraud.

Plaintiffs next allege that Enron inflated earnings by improperly accounting for impairments or losses to the value of long-term assets. NCC at ¶ 583. The thrust of Plaintiffs' claim is that Enron should have reduced the book value of ten assets due to a drop in market value of those assets. Because Enron did not do so, Plaintiffs argue that Enron overstated its earnings. To support this allegation, Plaintiffs accuse Enron of violations of SFAS No. 121, App. Tab 47. NCC at ¶ 587. Plaintiffs' position is wrong.

1. There are Many GAAP Rules Regarding Impairments.

GAAP provides many different tests regarding whether to write down "impaired" assets. The test to apply depends on the type of asset. Enron had assets that fit into four of the many tests. SFAS No. 121 applies to long-lived *assets* owned by a company. SFAS No. 115 applies to certain *investments* in equity and debt securities. APB 18 applies to write downs of equity method investments. Finally, Enron analogized for some assets to Investment Company Accounting as accepted in the AICPA Audit Guide for investment companies. In accordance with the AICPA's guidance, investment companies are required to carry all investments in its merchant portfolio, both public and private, at fair value.[61]

[61] SFAS No 115 ¶4 specifically states that SFAS 115 is not applicable to investment companies nor enterprises whose specialized accounting practices include accounting for substantially all investments in debt and equity securities at fair value.

Plaintiffs only mention and set out the tests for SFAS No. 115, App. Tab 48 and 121, App. Tab 47. SFAS No. 121 provides a list of events or changes in circumstances that trigger the need to do an "impairment" test on long-lived assets. The test itself is provided in SFAS No. 121, App. Tab 47 at ¶ 6. The test, however, only requires recognition of an impairment loss "[i]f the sum of the expected future cash flows *(undiscounted and without interest charges)* is less than the carrying amount of the asset." SFAS No. 121 ¶ 6 (emphasis added).

2. PLAINTIFFS' IMPAIRMENT ALLEGATIONS ARE ERRONEOUS.

Plaintiffs' Complaints fail first because Plaintiffs do not identify which of the ten assets discussed are Enron equity investments and which are long-lived assets. The Complaints do not raise an inference of fraud by alleging that Enron failed to apply an impairment test that does not apply. That Plaintiffs confuse the applicable standards does not state a claim of fraud. Only three of the assets specifically raised by Plaintiffs are long-lived properties requiring the application of SFAS No. 121: Broadband, Brazil and the MTBE facility which was sold to EOTT.

Second, Plaintiffs' Complaints fail because, even where SFAS No. 121 applies, Plaintiffs do not state facts from which one could infer that Enron failed to or improperly applied the test. Plaintiffs conclude that because the market value of an asset was below the book value, the test must have been improperly applied. That conclusion is wrong. Assets are sold at market value which may be less than book value. This does not imply that the asset was improperly tested for impairment under SFAS No. 121. The undiscounted value of the asset does not reflect market value since market value is by definition a reflection of discounted present value. As such, assets that have declined in market value often do not fail the impairment test under SFAS No. 121

because the rule tests only the undiscounted value of the asset. SFAS No. 115 requires that a loss be recorded for impairment to certain investments in equity and debt securities when the impairment is "other than temporary." SFAS No. 115, Tab 48 at ¶ 16 .

Third, even if Enron's accounting treatment were to have been in error, that does not state a fraud claim. Statements like "Enron failed to adequately reflect the deterioration in the value of the [sic] its investments," NCC at ¶ 586, and "these and other long-term assets were impaired long before Enron recorded these write-offs," even if true, are nothing more than improper implementation and mismanagement allegations which do not imply or support a strong inference of fraud. *Santa Fe Indus. v. Green,* 430 U.S. 462 (1997). Plaintiffs nowhere state, among other things: (1) that any specific error was material, (2) how accounting under their theory would have affected Enron's overall financial statements, (3) how it would have affected the stock price or investor decisions, (4) which Defendants were involved in performing impairment tests, (5) which Defendants had information regarding the need to perform impairment tests, (6) which Defendants knew that the assets were allegedly "impaired," (7) which Defendants knew that the assets were improperly listed on the balance sheet, under Plaintiffs' theory, (8) when that Defendant learned the information, (9) how he learned it or (10) any of the other facts required to be pleaded to state a claim under the PSLRA. Plaintiffs also fail to demonstrate in the Complaints how they apply the impairment test to conclude that it was improperly applied. Stating a conclusion without setting out the specific facts substantiating the conclusion violates the PSLRA. *DiLeo*, 901 F.2d 626-27; *In re K-Tel Int'l Sec. Lit.*, 107 F. Supp. 2d 994, 1000-01 (D. Minn. 2000).

3. PLAINTIFFS' ALLEGATIONS RELATING TO SPECIFIC INVESTMENTS AND TRANSACTIONS FALL SHORT OF THE LEGAL STANDARDS.

Plaintiffs assert two complaints about Azurix: (1) that Defendants wrote down a $287 million impairment loss in the third quarter of 2001 that should have been taken in 2000 (NCC at ¶¶ 588-592), and (2) that Enron had failed to disclose its stock pledged to guarantee the capitalization of Azurix/Marlin Water Trust. The latter point is wrong and neither allegation raises a fraud claim.

The Azurix/Marlin Water Trust guarantee was disclosed in note 10 to the financial statements as a contingent obligation:

> In connection with the 1998 financial restructuring (yielding proceeds of approximately $1.2 billion) of Enron's investment in Azurix, Enron committed to cause the sale of Enron convertible preferred stock, if certain debt obligations of the related entity which acquired an interest in Azurix, are defaulted upon, or in certain events, including, among other things, Enron's credit ratings fall below specified levels. If the sale of the convertible preferred stock is not sufficient to retire such obligations, Enron would be liable for the shortfall. Such obligations will mature in December 2001. The number of common shares issuable upon conversion is based on future common stock prices.

SEC App. Tab.15 at 84-85.

Plaintiffs do not allege why it was improper for Enron to recognize the impairment loss on Azuriz until the third quarter of 2001, other than that "defendants knew it was impaired from the time of acquisition." NCC at ¶ 591. But Plaintiffs do not allege facts demonstrating that Enron failed to perform an impairment test sooner or that Enron improperly applied the impairment test. Because Azurix was an Enron equity investment, SFAS No. 121 is not even the proper GAAP rule to apply. Rather under APB 18, Enron was required to determine whether the value of its investment had experienced "other than temporary" decline. Enron did that test when required for Azurix.

Enron recorded the $287 million charge that Plaintiffs raise regarding "asset impairments recorded by Azurix" because Azurix recognized an impairment of those assets during that quarter. Azurix was required to comply with SFAS No. 121 Tab 47 which, in addition to the undiscounted cash flow test discussed previously, provides for an impairment to market value when a board approved plan to sell assets is adopted. The Azurix board approved such a plan in the third quarter of 2001. Enron recorded and disclosed its share of the loss through the corresponding equity decline in Atlantic Water Trust.

Plaintiffs complain that Enron waited until the end of the Class Period to write off impairment losses for its Broadband "fiber impairment." In addition to the pleading failures noted above, Plaintiffs fail to allege facts that suggest how SFAS No. 121 was allegedly improperly applied to Broadband. If Plaintiffs had done so, they would have recognized two problems with their allegations. First, the $180 million charge on Broadband contained two parts: (1) severance costs and (2) impairment to reflect the reduced value of Enron's content services business, namely video on demand. The severance costs could not have been expensed until appropriate GAAP criteria occurred, which was the third quarter of 2001. EITF 94-3, App. Tab 63. Second, application of the SFAS No. 121 test to the "fiber impairment" would yield a conclusion that the impairment did not need to be recognized. In fact, the "fiber impairment" claim was not part of the $180 million charge on Broadband and has yet to be recognized by Enron because it did not fail the SFAS No. 121 test.

The last of Plaintiffs' allegations on impairment involves Enron's sale of MTBE to EOTT. Plaintiffs do not allege that the sale to EOTT was fraudulent. Plaintiffs simply challenge revenue that Enron reported through the use of mark-to market accounting. Enron sold its

MTBE facility to EOTT for $200 million. As part of the transaction, Enron and EOTT entered into contracts whereby Enron provided certain of the products needed to produce MTBE and purchased the MTBE from the plant for fixed prices. Because this contract related to energy commodities, Enron marked to market the transaction as required by EITF No. 98-10. As set out in Section III.E.1. of this Brief, Enron's accounting treatment was entirely proper under GAAP. Moreover, Enron also disclosed revenues from these transactions in note a to note 6a of the June 30, 2001 Form 10-Q:

> Enron recognized revenues from transactions with unconsolidated equity affiliates of approximately $1,111 million in the first half of 2001, including $125 million related to commodity contracts entered into in the second quarter.

SEC App. Tab 18 at 14.

G. PLAINTIFFS' MISCELLANEOUS ACCOUNTING ALLEGATIONS FAIL FOR SIMILAR REASONS.[62]

1. PLAINTIFFS' ALLEGATIONS REGARDING ENRON'S DEBT TO EQUITY RATIO ARE DUPLICATIVE.

Plaintiffs' claim that Enron presented materially misleading financial statements during the alleged class period by misstating Enron's "Debt to Equity" and "Ratio of Earnings to Fixed Charges" presented in its financial statements. NCC at ¶ 418(j). This issue is essentially duplicative of all of Plaintiffs' other accounting allegations because these ratios are determined by mathematical calculation after all of the numbers in the balance sheet are in place. Plaintiffs allege no fraudulent intent on the part of Enron or the Defendants in the debt to equity and ratio of earnings to fixed charges calculations. Plaintiffs also do not, or cannot, allege that the amounts were wrongly calculated based on the information provided in the balance sheet.

[62]Another accounting issue "snowballing" is addressed in Section V.D.2., *infra*.

Likewise, they do not plead who-what-when-where as to any individual Defendant. The claim of misstatement of these ratios cannot form an independent ground for fraud.[63]

2. PLAINTIFFS' RATING AGENCY DISCLOSURE ALLEGATIONS DO NOT RAISE FRAUD.

In various places throughout the Complaints, Plaintiffs allege that Enron misrepresented its financial condition to the rating agencies, (*see, e.g.* NCC at ¶ 83 (u), 567, 651), and that Enron did not deserve an investment-grade credit rating (NCC at ¶ 121 (i)). As has been shown repeatedly throughout this brief, Enron did fairly disclose its financial condition. The rating agencies are especially qualified to review and properly interpret company financial statements and are familiar with accounting treatments and use of partnerships and SPE's. In fact, several partnerships that Plaintiffs' complain about, such as Whitewing and Atlantic Water Trust were all separately reviewed and rated by the rating agencies. Enron's treatment by the rating agencies cannot be the basis of a fraud claim against the Defendants.

3. PLAINTIFFS MISAPPLY GAAP REGARDING AUDIT ADJUSTMENTS.

Plaintiffs challenge Enron's accounting judgments regarding the need to make $51 million in audit adjustments in 1997 that ultimately became part of the restatement in 2001. Plaintiffs' claim that $51 million was a material audit adjustment in 1997 that should have been recorded because the $51 million exceeded 10% of Enron's 1997 recurring net income and 48% of Enron's net income. As with the other accounting issues, Plaintiffs do not accuse Enron of

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[63]It should also be noted that the restated debt to equity ratio would not have affected Enron's investment grade status. The restatement did not impact Enron's first and second quarter 2001 debt at all. The only debt coming back on balance sheet due to the restatement was JEDI. Chewco had already been consolidated and so the Chewco/JEDI debt was already on the balance sheet in the first two quarters of 2001 and Enron had maintained its investment grade levels with the Chewco debt on the balance sheet.

fraud, just faulty application of the accounting rules. Plaintiffs accounting interpretations are not clear, however, and subject to different conclusions by different accountants.

Proposed audit adjustments are not uncommon. The question is whether they need to be recorded and the answer depends on the materiality of the adjustment. Materiality cannot be reduced to a numerical calculation. FASB Concepts Statement No. 2. Instead, GAAP allows the weighing of qualitative issues as well. *Id.*

As evidenced by Andersen's unqualified audit opinion, Andersen determined that the amounts were not material. NCC at ¶ at 955. While the $51 million was 48% of Enron's 1997 net income, the net income was low that year because of a one time charge. The income for 1994 had been $453 million, in 1995 had been $520 million and in 1996 had been $584 million. It was not unreasonable for Andersen to consider the overall income trend of Enron in determining whether the adjustment would be material. Moreover, while the GAAP provision cited by Plaintiffs -SAB 99 - does not support their point, Plaintiffs admit that the rule was not even implemented until 1999. NCC at ¶ 517, fn. 10. *See, Mortenson v. Americredit Corp.*, 123 F. Supp. 2d 1018, 1025-26 (N.D. Tex. 2000) (clarifications to GAAP made after the fact does not infer scienter absent a showing that the practice was so out of step with the rest of the industry as to raise a strong inference of fraud.).

IV. THE RESTATEMENT DOES NOT CREATE A STRONG INFERENCE OF FRAUD.

On November 8, 2001, Enron, through the filing of its Form 8-K with the SEC, disclosed to the markets certain adjustments to be made in its financial statements back to 1997 (the "Restatement"). Plaintiffs' Complaints treat the Restatement as if it were Enron's admission of securities fraud. This is legally and factually incorrect. First, Enron reaffirmed that it had earlier believed (and its consultants had advised) that its statements were accurate. It is well established, through the decisions of the Fifth Circuit and other courts, that the fact of a restatement does not establish fraud. *In re SCB Computer Technology, Inc. Sec. Lit.*, 149 F. Supp. 2d 344, 346 (W.D. Tenn. 2001)(magnitude of restatement alone dos not establish scienter); *In re Baker Hughes Sec. Lit.*, 136 F. Supp. 2d 630, 648-49 (S.D. Tex. 2001) (allegations of accounting improprieties and restated financial figures insufficient to establish scienter); *Mortenson v. Americredit Corp.*, 123 F. Supp. 2d 1015, 1017-18 (N.D. Tex. 1999) (restatement of financial figures does not create a strong inference of fraud); *Lovelace*, 78 F.3d at 1020 (amended filing does not admit that prior filings were misleading).

The courts recognize that there are many events that can cause a restatement. In considering the sufficiency of a complaint based upon a restatement, the court must analyze the restatement to determine if it carries an indicia of fraud. The court subjects the claims about a restatement to the same analysis of pleading particularity as it does with the company's other statements and disclosures. *Chalverus v. Pegasystems, Inc.*, 59 F. Supp. 2d 226, 233 (D. Mass. 1999) (a plaintiff adequately pleads financial fraud based on improper revenue recognition by alleging a particular transaction in which revenues were improperly recorded, the name of the customer, the terms of the transaction, when the transaction occurred, and the approximate amount of the fraudulent transaction).

The analysis of Enron's Restatement begins with an understanding of its components, a discussion remarkable for its absence from the Plaintiffs' eight hundred pages. The Restatement has four components: (1) a recognition of previously unrecorded auditor adjustments that were individually immaterial and not, therefore, previously subject to disclosure; (2) the need to consolidate a previously unconsolidated SPE ("Swap-Sub") due to an accounting "misjudgment" by Enron's outside auditors; (3) the need to consolidate a previously unconsolidated joint venture partnership ("Chewco/JEDI") because of management's discovery of new information that appeared to disqualify Chewco as an SPE; and (4) an adjustment to equity arising because of an accounting error *and* a decision previously made in September to unwind the Raptors structures.[64]

A. THE RECOGNITION OF PREVIOUSLY UNRECORDED AUDIT ADJUSTMENTS IS NOT ALLEGED TO BE FRAUDULENT.

One component of the Restatement relates to previously unrecorded auditor adjustments that had been deemed immaterial in prior years. While GAAP did not require these adjustments to be made earlier, Andersen required the adjustments to be made as a by-product-of the Restatement.[65] Therefore, no inference of fraudulent activity can attach.

B. ENRON'S AUDITOR ADVISED ENRON THAT THE 3% TEST WAS MET AS TO CONSOLIDATION OF SWAP-SUB.

In mid-1999, Enron entered into a transaction with LJM1, the original investment partnership sponsored by Andy Fastow, and an SPE formed by LJM1, known as Swap-Sub. The transaction's purpose was to hedge the market fluctuations of Enron's position in the stock of Rhythms-Net Communications. As a qualifying SPE, the derivative entered into between Enron and Swap-Sub hedging Rhythms-Net Communications was reflected in Enron's financial statements (as opposed to eliminated, which would have been required if Swap-Sub was

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[64]The Restatement at page 3 referenced three components. Here, the Rhythms and Chewco SPE matters are separately treated, resulting in an additional component.

[65]*See* remarks of Joseph F. Berardino, former Managing Partner Chief Executive Officer of Andersen before the U.S. House of Representatives Committee on Financial Services, December 12, 2001. App. Tab 52.

consolidated by Enron). This transaction was disclosed as part of Enron's related party disclosures. Moreover, as discussed above, these related party disclosures included the information that the structure's creditworthiness changed with fluctuations in Enron's stock price. *See* Section III.B.1.2, *supra*.

As part of an accounting review of related party transactions in October 2001, Enron and Andersen discovered that the valuation of Enron stock held by Swap-Sub had not taken into account the fact that the Enron stock was restricted, which had the effect of reducing LJM1's equity in the structure such that Swap-Sub no longer qualified as a SPE. As a result, Swap-Sub was consolidated by Enron, and as discussed above, the impact of the Rhythms-Net derivative transaction between Enron and Swap-Sub had to be eliminated. This was a highly technical accounting issue and a simple oversight.

Andersen's CEO in his December 12, 2001, Congressional testimony states:

> In evaluating the 3 percent residual equity level required to qualify for non-consolidation, there were some complex issues concerning the valuation of various assets and liabilities. When we reviewed this transaction again in October 2001 we determined that <u>our team's initial judgment</u> that the 3 percent test that was met was in error. We promptly told Enron to correct it.

Remarks of Joseph F. Beradino before the United States House of Representatives Committee on Financial Services, December 12, 2001. No inference or suggestion of fraud should attach to this matter because of the technical nature of the error. *See, e.g., Wells v. Monarch Corp.*, 129 F.3d 1253, 1997 WL 693032 at *5 & n.15 (1st Cir. 1997) (affirming dismissal, despite Ernst having "made many mistakes"; "Other circuits have held that scienter in Section 10(b) actions against accountants or independent auditors is not established merely through a showing of an error of judgment or a misapplication of accounting principles."); *In re Microstrategy, Inc. Sec. Lit.*, 115 F. Supp. 2d at 637-38 (violations of GAAP rules are probative of fraudulent intent if the rules violated are simple ones). Also, though unconsolidated, investors were aware of the transaction's economics by virtue of the related party disclosures. *See* Section III.B.2, *supra*.

Plaintiffs make no specific allegations of fraud regarding the valuation error in the structure of Swap Sub that led to the consolidation of Rhythms-Net. The Complaints fail to attribute the error to any identified defendant. The Complaints fail to allege that the error was intentional or that it was known to any identified persons prior to its discovery as recounted above. In short, the necessary particularized allegations relating to this accounting error are absent.

c. CHEWCO/JEDI FINANCIAL ACTIVITIES WERE CONSISTENTLY DISCLOSED, AND EVEN UPON RESTATEMENT, CONSOLIDATION HAD "NO EFFECT ON ENRON'S CURRENT FINANCIAL POSITION."

JEDI was a joint venture between Enron and Chewco. Chewco was itself an SPE. JEDI's financial results were not consolidated on Enron's financial statements because Enron did not consolidate the results of partnerships in which Enron did not have voting control. SFAS 94, APB 18; EITF No. 96-16, App. Tab 64. Again, as part of its examination of related party transactions in October 2001, Enron discovered that Chewco's capital structure included a collateral guaranty agreement that arguably had the effect of disqualifying Chewco's status as an SPE under EITF 90-15, App. Tab 62, which resulted in the consolidation of the JEDI partnership.

As with Rhythms-Net, even though JEDI was an unconsolidated partnership, Enron consistently disclosed its financial activities as part of its note disclosures. As reaffirmed in the Restatement, the consolidation had "no effect on Enron's current financial position." SEC App. Tab 19, at 2. The Complaints do not plead that this statement is false.

The Complaints fail to identify any specific person responsible for failing to note that the collateralized guaranty agreement disqualified Chewco as an SPE. It fails to identify who knew what and when about Chewco's capital structure. It fails to allege with particularity that this was anything other than an oversight unknown to upper management. Enron had every incentive to ensue that Chewco was adequately capitalized. The presumption that a company would not have acted intentionally in a way to cause itself economic harm precludes a strong inference of fraud based on the alleged facts. *See Laro, Inc. v. Chase Manhatten Bank*, 866 F.Supp. 132, 138 (S.D.N.Y. 1994).

D. THE RESTATEMENT EQUITY ADJUSTMENT DOES NOT INFER FRAUD.

The fourth and last component of the Restatement was an equity adjustment of $1.2 billion relating to the Raptors structures. Enron accounted for the Enron shares sold in April 2000 in Raptor I in exchange for a $172 million promissory note, as an increase to "notes receivable" and to "shareholders' equity." This increased shareholders' equity by $172 million in Enron's second, third, and fourth quarter 2000 financial reports. Enron made similar entries when it sold Enron stock contracts in March 2001 as part of Raptors II and IV for notes totaling $828 million. This accounting treatment increased shareholders' equity by a total of $1 billion in Enron's first and second quarter 2001 financial reports. Enron claims that Andersen was aware of, and approved, the accounting treatment for the Enron stock derivatives contracts sold by the Raptor SPE's in the first quarter of 2001.

In September 2001, Andersen and Enron concluded that the prior accounting entries were wrong, and the proper accounting for these transactions would have been to show the notes receivable as an offset to shareholders' equity, thereby eliminating the $1 billion increase in shareholders' equity discussed above. It must be emphasized that this adjustment was a *non-*cash write-down and had no impact on earnings or cash flow. Enron eventually decided to correct these mistaken entries in its third quarter 2001 financial statements. At the time the error was first discovered, Enron and Andersen concluded (using a qualitative and quantitative analysis) that the error was not material, and a restatement was not necessary, particularly due to relatively little impact on Enron's debt-to-equity ratio. When Enron announced in the Restatement that it would restate its prior financials for other reasons, however, it included the reduction of shareholders' equity. The correction of the error in Enron's third quarter financial statements resulted in a reduction of $1 billion ($172 million plus $828 million) to its previously overstated equity balance.

Enron actually recorded a $1.2 billion reduction to shareholders' equity in its third quarter 2001 financial statements. One billion dollars of this reduction resulted from the netting of the notes receivable against shareholders' equity discussed above. The additional approximately $200 million resulted from the fact that the notes receivable that Enron held for the stock and stock contracts sold to the Raptors were valued at a total of $1.9 billion, while the Enron stock and stock contracts held by the Raptors, which Enron took back when the Raptors were terminated, were valued at $2.1 billion. The $200 million difference was recorded as a reduction to shareholders' equity, and added to the $1 billion reduction that was recorded to correct the accounting error.

The equity adjustment was first announced on October 16, 2001, as part of an earnings release and analyst's conference. Moreover, the adjustment was necessary not only because of the accounting issue but also because management independently decided in September 2001 to unwind the Raptors transactions.

These facts give rise to no inference of fraud. Plaintiffs' Complaints fail to allege that this accounting error resulted from an intentional design to mislead. It fails to attribute the error to any specific person. It fails to allege any specific market effects attributable to the error. This fact suggests that the market placed little importance on this item, originally deemed immaterial, due to the size of the adjustment, its non-cash nature, and the fact that it had no net effect. Additionally, the note receivable was disclosed in note 8 of the First Quarter 2001 10Q. Sec. App. Tab 17, at 15. As such, this subject fails the strict pleading requirements of the PSLRA and Rule 9(b).

E. THE FOLLOWING CONCLUSIONS ABOUT THE RESTATEMENT ARE PROPER.

Examining each of the Restatement's elements, one finds no true allegation of "fraud" associated with the accounting issues raised in the Restatement. The Restatement resulted from oversight or errors about complex accounting issues or technical SEC requirements with no implications of fraud. Even as to Chewco, where issues of improper conduct by some are suggested, those suspicions and the Plaintiffs' Complaints do not implicate the Defendants.

V. PLAINTIFFS' ALLEGATIONS REGARDING ENRON'S BUSINESS UNITS SHOULD BE DISMISSED.

A. PLAINTIFFS ALLEGATIONS REGARDING ENRON'S WHOLESALE ENERGY OPERATIONS AND SERVICES BUSINESS ARE INSUFFICIENT AS A MATTER OF LAW.

1. PLAINTIFFS' ALLEGED MISREPRESENTATIONS CONCERNING WEOS ARE INSUFFICIENT TO SATISFY THE PSLRA'S PLEADING REQUIREMENTS.

Throughout the Consolidated Complaints, Plaintiffs allege numerous statements by Enron and by independent analysts to the effect that Enron's Wholesale Energy Operations and Services ("WEOS") was profitable and had strong prospects for growth. Plaintiffs, however, never explain how or why these statements were false or misleading -- because the cited statements were, in fact, true. WEOS always was a successful and profitable part of Enron's business. Plaintiffs here failed to plead any facts to the contrary.

Enron's restatement of earnings for some transactions and even Enron's filing for bankruptcy, cannot retroactively color as false or misleading any or all statements previously made by Enron or its representatives. As the Ninth Circuit noted:

> Securities fraud cases often involved some more or less catastrophic event occurring between the time the complained of statement was made and the time a more sobering truth is revealed (precipitating a drop in stock price).... When such an event has occurred, it is clearly insufficient for plaintiffs to say that the later, sobering revelations make the earlier, cheerier statement a falsehood. In the face of such intervening events, a plaintiff must set forth, as part of the circumstances constituting fraud, an explanation as to why the disputed statement was untrue or misleading *when made*.

In re GlenFed, 42 F.3d at 1548-49. But there was no "catastrophic event" for WEOS, even in hindsight. Plaintiffs' use of sweeping allegations is no substitute for the particularized statement--by--statement analysis commanded by the PSLRA. *Lain v. Evans*, No. 3:99-CV-2594-H, 2000 U.S. Dist. Lexis 9257, at *8-*9 (N.D. Tex. June 30, 2000)(rejecting plaintiff's objection to "piecemeal" approach to evaluation of its allegations of fraud; "[t]he PSLRA does not permit the Court to look at the broad picture to determine if Plaintiff has properly plead its claim").[66]

In the entire *Newby* Consolidated Complaint, there appear to be 91 allegations that relate in any way to WEOS. None are sufficient to state a claim.

A. PLAINTIFFS' ALLEGATIONS CONCERNING WEOS ARE VAGUE AND CONCLUSORY.

- Twenty-two of Plaintiffs allegations are too vague and conclusory to satisfy Rule 9(b) and the PSLRA's pleading requirements. In fact, many of these allegations are simply rote paragraphs repeated over and over throughout the Consolidated Complaints.[67]

- Another thirteen of the allegations are either forward-looking statements that are protected by safe-harbor language or the bespeaks-caution doctrine or simply immaterial puffing.[68]

- Plaintiffs also cite another twenty-eight statements concerning quarterly or annual earnings reports, and simply conclude that they were materially false or misleading in light of the subsequent restatement of earnings. As demonstrated below, the mere fact that Enron restated earnings does not make any of these statements retroactively false or misleading.[69]

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[66] *See* Order Approving Sale of Enron's Wholesale Trading Business, *In re Enron Corp. et al.*, No. 01-16034 (AJG) (Jan 22, 2002). It is well settled that this Court may take judicial notice of UBS Warburg's purchase of Enron's wholesale trading entity. *See Kramer v. Time Warner Inc.*, 937 F.2d 767, 774 (2d Cir. 1991) (observing that "courts routinely take judicial notice of documents filed in [other actions], ... not for the truth of the matters asserted in the other litigation, but rather to establish the fact of such litigation and related filings.") Moreover, subsequent events attest to the profitability of Enron's wholesale business and the accuracy of the statements concerning that business which Plaintiffs attack: (1) UBS Warburg moved quickly to purchase that segment of Enron from the bankrupt estate; and (2) the wholesale trading entity created by the sale, UBS Warburg Energy, received an AA+ credit rating.

[67] *See* at ¶¶ 2, 14, 36, 121(e), 121(j), 155(e), 155(o), 214(e), 289, 300(e), 300(r), 314, 339(e), 339(r), 549-57.

[68] *See* at NCC at ¶¶ 109, 110, 136, 271-72, 274, 283, 292, 293, 294, 307, 336, 337.

[69] *See* at NCC at ¶¶ 112, 118, 119, 128, 144, 156, 157, 196, 197, 223, 224, 246, 247, 262, 263, 271-72, 281, 282, 286, 309, 316, 317, 328, 329, 331, 332, 368.

- Finally, Plaintiffs cite twenty-eight statements contained in various independent analyst reports and attempt to attribute those statements to Enron. These statements, however, can only be attributed to Enron to the extent that the independent analysts were entangled with Enron.[70] Plaintiffs allege no facts to support an inference that they were.

Plaintiffs recycle three paragraphs throughout their Consolidated Complaint, each of which purports to allege how Enron misrepresented or improperly conducted its wholesale business. They are quoted below.[71] On their face, these rote paragraphs are vague and conclusory, and devoid of any factual support. They fail to identify the specifics of the general conduct alleged, who participated in it and how, or why the conduct led to specific material inaccuracies in specific public filings or statements.

i. Rote Allegation I

Plaintiffs repeat verbatim, at least five times, the following allegation:

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[70] *See* at NCC at ¶¶ 120, 179, 232, 266, 280, 284, 285, 287, 290, 304, 308, 321, 334, 338, 370, 371, 372, 373, 233, 251, 255, 257, 265, 267, 268, 269, 322, 333.

[71] *See*, *e.g.*, NCC at ¶ 36 ("Enron misused and abused mark-to-market accounting throughout its entire business to grossly inflate its reported revenues and profits during the Class Period .... In Enron's wholesale energy business this was done by assigning unrealistic values to wholesale energy transactions which inflated current period income."); NCC at ¶ 121(e) (The results of Enron's wholesale (WEOS) business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. First, by phony or illusory hedging transactions with entities that were not independent of Enron. Second, by the abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And third, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve."); NCC at ¶ 121(j) ("The forecasts for strong continued revenue and earnings growth for Enron's WEOS and for continued growth and future profitability of the EES operations were false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims for future growth that were being made."

> The results of Enron's wholesale (WEOS) business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. First, by phony or illusory hedging transactions with entities that were not independent of Enron. Second, by the abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And third, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve." And Enron had not effectively hedged its WEOS merchant investment portfolio as most of the purported hedges were with non-independent parties in transactions structured such that the hedge depended on Enron stock and thus Enron was still at risk.[72]

NCC at ¶ 121(e) (emphasis omitted).[73]

This allegation fails to satisfy the most basic pleading requirements of Rule 9(b) and the PSLRA. First, Plaintiffs fail to identify which hedge transactions were purportedly illusory, how they were "illusionary," who the purported non-independent third parties were, or *how* WEOS earnings were manipulated by the allegedly illusory hedging transactions. The Complaints fail to identify any specific statements regarding hedges that supposedly were misleading, *where* the statements were made, *who* made them, or *when.*

Second, Plaintiffs allege that Enron adopted "unreasonable contract valuations and economic assumptions." They again provide no supporting facts. Can this Court perform the mandatory "piecemeal" analysis without being told <u>which</u> contracts, which "valuations and economic assumptions" within those contracts, or who Plaintiffs allege they were "unreasonable"? Third, Plaintiffs' allegations concerning Enron's "moving the curve" provide no specific examples of *when* or how this was done or by *whom.* For example, in what "quarter" did a

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[72]This allegation is, at best, a conclusory allegation that Enron's business practice in WEOS was ineffective – a conclusion not only unsupported by factual allegations, but one that fails as a basis for a fraud claim, even if it were supportable.

[73]*See also* NCC at ¶¶ 155(e), 214(e), 300(e), 339(e).

specific Defendant (or Enron for that matter) arbitrarily adjust a value, and by what amount? Plaintiffs refuse to tell.

The Fifth Circuit's recent decision in *Nathenson* is particularly relevant here. In *Nathenson* putative class representatives alleged that defendants' statements regarding certain medical trials were misleading. The plaintiffs in *Nathenson* used broad allegations and conclusory labels similar to those used in the Complaints. Particularly, the *Natheson* plaintiffs alleged:

> that the Phase III trials were 'materially flawed' such that their reported positive results were unreliable. These alleged flaws included faulty randomization of participants, pre-screening participants to exclude those suffering from side-effects, conflicts of interest in those operating the test centers, and the existence of severe side effects.[74]

Although the allegations purported to describe how the trials were flawed (more than the *Newby* Plaintiffs have done), even those allegations were found conclusory, by the Fifth Circuit:

> The allegations about the Phase III statements suffer from a lack of required specificity, either in pin-pointing the particular misleading statement (other than general statements that the Phase III results were "positive") or identifying with any degree of detail how these shortcomings impacted the trials.[75]

Numerous other cases hold similarly. For example in *In re Splash Tech. Holdings, Inc. Sec. Litig.*, 2000 WL 1727377 *16, (N.D. Cal. 2000), the "[plaintiffs] allege[d] that Splash deliberately shipped excessive quantities of its product to Fuji Xerox and Xerox during June 1997 in order to artificially boost revenues and earnings for the quarter ending June 30, 1997." The court, however, found the lack of specific, factual allegations explaining how this allegedly occurred, or its specific effect, fatal to Plaintiffs' claims:

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[74]*Nathenson*, 267 F.3d at 419.

[75]*Id.* The Fifth Circuit affirmed dismissal of the complaint. *Id.*

> Plaintiffs again fail to provide any particular basis for believing this "channel stuffing" occurred. For example, they fail to allege any particular conversation between the customers and Splash. Without such a basis, the allegation of "channel stuffing" is conclusory, and the inference of false statements unavailing.

Id.[76] Plaintiffs' conclusory allegations regarding the WEOS business line should be stricken.

ii. Rote Allegation II

Plaintiffs also plead nearly verbatim, at least five times, and again with no particularity:

> As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's WEOS and EES operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified –thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims for future growth that were being made.[77]

Having conclusorily pled (Rote Allegation I) that WEOS' operations were based on unspecified faulty valuations and assumptions of the contracts in which WEOS dealt, Plaintiffs

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[76]Similarly, in *In re Party City Sec. Lit.* 147 F.Supp.2d 282 (D.N.J. 2001), plaintiffs alleged that:

> 'Party City's financials ... were materially false and misleading and lacked any reasonable basis because, as defendants knew (or were reckless in not knowing) and failed to disclose to the investing public, the Company's internal financial and accounting systems had failed to keep up with the Company's rapid and aggressive expansion of stores and were not functioning in a manner so as to produce reliable financial results and in accordance with GAAP. Indeed, as a result of high turnover in the Finance Department ... and the failure of the Company's internal financial and accounting systems to generate accurate financial information ... the Company's financial results ... were materially inaccurate and should not have been released to the investing public.'

147 F.Supp.2d at 301. The court, however, held such allegations insufficiently specific to carry plaintiffs' burden: "The Plaintiffs, however, do not specify which 'systems' were inadequate, how they were inadequate, which financial personnel left Party City or how these purported deficiencies affected the financial results. As discussed, such conclusory allegations are insufficient under Rule 9(b) and the PSLRA." *Id.* (citing *In re Burlington Coat Factory Sec. Lit.*, 114 F.3d 1410, 1418 (3d Cir.1997)).

[77]*See also* NCC at ¶¶ 121(j); 155(o), 214(q), 300(r), 339(r).

then plead that their unsupported conclusion justifies the further assumption that unspecified forecasts by Enron about WEOS's future operations were false or misleading.[78] Once again, Plaintiffs fail to provide any specifics to support this second, wholly conclusory allegation. Plaintiffs provide no factual basis to explain ***why*** forecasts for WEOS were false or baseless <u>when</u> *made,* nor do they even <u>identify</u> specific forecasts. The absence of any factual details is fatal to Plaintiffs' claim. *BMC,* 183 F.Supp.2d at 865 n.13.

iii. Rote Allegation III

Plaintiffs also make sweeping claims regarding Enron's Merchant Assets within WEOS, again entirely omitting any facts to support them:

> During the Class Period, Enron issued false and misleading financial statements that materially overstated the value of its holdings in *various* portfolio companies ("Merchant Assets") by mischaracterizing *many* of its Merchant Assets as having readily determinable values. ... Enron falsely recorded its Merchant Assets as if they all had readily determinable values. *This was not the case.* ... Enron also improperly valued its Merchant Assets. In order to meet earnings expectations Enron would: (1) manipulate the original assumptions; (2) utilize inconsistent valuation approaches; or (3) establish arbitrary milestones.[79]

The piecemeal analysis that is mandated by the PSLRA is impossible under this pleading. Before this Court and Defendants can determine the specific portions of financial statements that

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[78]Even if WEOS had been unprofitable, instead of being one of Enron's successes, Plaintiffs' argument is nonsensical. It relies upon the nonsense that a company that has lost money cannot project a turnaround, profits, and <u>future</u> success.

[79]NCC at ¶¶549-57. Plaintiffs make two other allegations with respect to WEOS.

> "In Enron's wholesale energy business this was done by assigning unrealistic values to wholesale energy transactions which inflated current period income." NCC at ¶36.

> "Enron and its bankers continued to assure investors and the markets that Enron's core wholesale energy and retail energy businesses were very strong." NCC at ¶314.

These statements, like the three allegations already set forth above, are conclusory and vague – and thus likewise inadequate for the reasons explained below.

are at issue, they are forced to speculate about which of the "various portfolio companies" are referred to by Plaintiffs. Plaintiffs say "many" were mischaracterized, but which ones? And how?

Likewise, the Complaints do not specify what assumptions supposedly were "manipulated," how they were manipulated, who did so or what the specific result was of that supposed manipulation. They do not specify *the* "inconsistent valuation approaches" supposedly used by Enron. The Complaints fail to specify ***how*** or why those allegedly "inconsistent valuation approaches" would result in falsified disclosures or financial results. The same is true as to the supposed "arbitrary milestones."

In short, after a full reading and painstaking parsing of the Complaints, the defendants have no clue as to what any of these alleged practices mean either as a definitional matter or in terms of translating Plaintiffs' vague allegations into some identifiable misstatement of WEOS's operations. The Court is given no guidance either. The Complaint also fails to specify ***what*** statements Defendants made which "mischaracterized" Enron's Merchant Assets "as having a readily determinable value," ***who*** made them, why they Merchant Assets would not in fact have a "readily determinable" value, or ***how*** those unspecified, alleged statements otherwise were misleading.

Courts have consistently rejected similar vague, conclusory allegations. *See, e.g., Zishka v. American Pad & Paper Co.*, 2001 WL 1748741, *2 (N.D. Tex. 2001). In *Zishka*, Judge Lynn dismissed a federal securities claim that alleged defendants had improperly recognized revenues, but failed to give adequate details of the methods or circumstances of that alleged fraud.[80] The Court stated:

> The claims of improper revenue recognition and problems involving returns of goods … are legally insufficient. Plaintiffs do not provide sufficient detail to support those allegations, such as describing specific transactions in which there was improper recognition, the materiality of such transactions [or] … any alleged impact on the December 1997 charges.

Id. at *2.

B. THE RESTATEMENT OF EARNINGS DOES NOT SUPPORT PLAINTIFFS' ALLEGATIONS.

A large portion of the statements cited by Plaintiffs regarding Enron's WEOS business are simply announcements of quarterly and annual results.[81] Plaintiffs have taken the approach

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[80]On reconsideration, after the Fifth Circuit decided *Nathenson v. Zonagen,Inc.*, 267 F.3d 400 (5th Cir. 1001) the Court proceeded to dismiss the remaining defendants for failure to show more than motive and opportunity. *Zishka v. American Pad & Paper Co.*, 2001 WL 1645500 (N.D. Tex Dec. 20, 2001).

[81]*See, e.g.*, NCC at ¶ 112 ("On 7/14/98, Enron announced its better-than-expected 2ndQ 98 results, stating: Enron Corp. announced today 1998 second quarter earnings of $[0.21] per diluted share, compared to $[0.19] ... in the second quarter of 1997. The strong results were led by growth in Enron's largest business, Wholesale Energy Operations and Services ...."); NCC at ¶ 118 ("On 10/13/98, Enron reported better-than-expected 3rdQ 98 results: Enron Corp. announced today 1998 third quarter earnings of $[0.235] per diluted share compared to $[0.23] ... in the third quarter of 1997. The results were led by continued growth in Wholesale Energy Operations and Services…. Enron has demonstrated its ability to consistently generate solid and predictable earnings, as evidenced by the 60 percent increase in earnings in our Wholesale business," said Kenneth L. Lay, Enron Corp. chairman and chief executive officer."); NCC at ¶ 128 ("On 1/19/99, Enron reported better-than-expected 4thQ 98 and 98 results: Enron Corp. announced today a 16 percent increase in 1998 earnings per share to $[1.005] from $[.87] in 1997.... [N]et income increased 36 percent to $698 million from $515 million during the year.... [F]ourth quarter 1998 earnings of $[0.24] per ... share, which compares to $[0.17] in the 1997 period ...." "Our Wholesale Energy Operations and Services business led the company's growth during the year, achieving record levels ... in earnings."); NCC at ¶ 144 ("On 4/13/99, Enron reported better-than-expected 1stQ 99 results: Enron Corp. announced ... 99 first quarter net income increased 18 percent to $253 million compared to $214 million in the first quarter of 98. Enron also reported earnings per ... share of $0.34 ... compared to $0.325 .... Our first quarter

that all of these statements must have been false at the time they were made because Enron subsequently was forced to restate its earnings -- for unrelated reasons. Again, such a conclusory approach, without specific allegations to support an inference of fraudulent intent, is insufficient under the PSLRA. *See, e.g., Branca v. Paymentech, Inc.*, 2000 U.S. Dist. LEXIS 1704, *35-36 (N.D. Tex. Feb. 8, 2000) (restatement of earnings alone does not raise a strong inference of scienter).

2. PLAINTIFFS FAIL TO PLEAD FACTS SUFFICIENT TO SUPPORT EVEN AN INFERENCE THAT ANY OF THE STATEMENTS THEY CITE CONCERNING WEOS'S PERFORMANCE WERE KNOWN TO BE FALSE WHEN MADE.

The PSLRA requires Plaintiffs to provide detailed information in their allegations demonstrating that the named Defendants knew that any particular statements attributed to them concerning WEOS's performance were materially false or misleading at the time they were made. 15 U.S.C. § 78u-4(b)(2) ("[A] complaint shall, *with respect to each act or omission* alleged to violate this chapter, state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind.") (Emphasis supplied). A complaint that fails to specify sufficient factual details as to <u>each</u> Defendant supporting an inference that Defendants acted with the intent to commit fraud, must be dismissed. *See Tuchman*, 14 F.3d at 1069; *In re GlenFed*, 42 F.3d at 1548-49 (same). Allegations that plead "motive" and "opportunity," alone, are insufficient. *Nathenson*, 267 F.3d at 410-12; *In re Azurix Corp. Sec. Litig.*, 2002 WL 562819 *21 (S.D. Tex. Mar. 21, 2002).

Plaintiffs claim that Enron announced better-than-expected 1st Q 99 results on April 13, 1999, and stated in part:

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results reflect the continued strength of our worldwide energy businesses. Each region of our wholesale business continued to grow during the quarter in terms of ... profitability.)

> Our first quarter results reflect the continued strength of our worldwide energy businesses. Each region of our wholesale business continued to grow during the quarter in terms of ... profitability....[82]

Plaintiffs further allege that Enron discussed WEOS's success in calls with analysts and in documents:

> Enron's 00 Annual Report also discussed Enron's various businesses: Wholesale services is Enron's largest and fastest growing business, with sustainable growth opportunities in each of its markets....[A]nd our competitive position is growing stronger.
>
> Enron Wholesale Services
>
> ... [W]holesale services income before interest, minority interests and taxes (IBIT) increased 72 percent to $2.3 billion.... [W]e have had 20 consecutive quarters of year-over-year growth.[83]

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[82]NCC at ¶ 144; *see also* NCC at ¶ 177 ("On 10/12/99, Enron reported better-than-expected 3rdQ 99 results: Enron Corp. announced ... a 33 percent increase in net income to $223 million for the third quarter of 1999, compared to $168 million in the third quarter of 1998. Enron also announced a 13 percent increase in earnings per diluted share to $0.27 for the most recent quarter, compared to $0.24 a year ago.... "The scale and scope of Enron's wholesale businesses provide tremendous competitive advantages in the rapidly growing, deregulating energy markets, enabling Enron to consistently achieve strong earnings growth."); NCC at ¶ 223 ("On 4/12/00 Enron reported better-than-expected 1stQ 00 results: Enron Corp. announced today an 18 percent increase in earnings to $0.40 per diluted shares for the first quarter of 2000. Net income increased 34 percent to $338 million during the quarter....".... "Wholesale volumes increased 43 percent to record levels, demonstrating the strength of our worldwide energy networks and the tremendous success of EnronOnline."); NCC at ¶ 196 ("Our wholesale business again registered strong profitability and growth in the rapidly expanding, deregulating energy industry worldwide."); NCC at ¶ 179 "In Houston. In the conference call and in follow-up conversations with analysts and in formal presentations and break-out sessions at the analyst conference, they stated: Enron had a very strong third quarter. Enron's wholesale business continued to evidence the tremendous competitive advantages that are the major factor in Enron consistently achieving strong earnings growth. Enron continued to be very confident in the prospects for its wholesale businesses. Enron's new communications business was pursuing a business plan modeled after its successful wholesale energy networks. Enron was rapidly developing a presence in major global markets and making large fibre investments. Enron expected this business to continue solid progress. The 3rdQ results Enron announced were reflective of the strong earnings power and the momentum at Enron. Wholesale business was very, very strong and had a good quarter. All the fundamentals in that business were looking very positive."); NCC at ¶ 197 "In the conference call and in follow-up conversations with analysts and in formal presentations and break-out sessions at the analyst conference, they stated: Enron had a tremendous year in 1999. Its wholesale energy business led the strong financial results continuing high levels of both profitability and growth. A great year for the wholesale business."); NCC at ¶ 224 (same); *see also* NCC at ¶ 294.

[83]NCC at ¶ 293.

Plaintiffs, however, do not cite <u>any</u> facts to show that Enron's statements about WEOS were false. For example, was there a quarter in which WEOS did not truly have growth over the prior period, and if so, when and by how much? Plaintiffs must say much more to satisfy Rule 9(b) and to raise a "strong inference" that any of the defendants knew that the foregoing statements were false or misleading (let alone materially so) when made.[84] *See* NCC at ¶¶ 395-417. Plaintiffs allege only that: (1) the "Enron Defendant[s] ... sold substantial amounts ... of his or her Enron stock" (but point to no false facts as to WEOS at the times of such sales, or any other time);[85] (2) had senior management positions in the company;[86] and (3) "had access to the adverse non-public information about [Enron's] business, partnerships and investments, finances, products, markets and present and future business prospects via access to internal corporate documents."[87] Courts routinely reject these very sort of allegations as insufficient to support a strong inference of scienter.[88]

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[84]Plaintiffs' also attempt to hold all individual defendants liable for every statement, even those attributed generally to Enron. Such "group pleading" or group responsibility do not suffice under Rule 9(b) and the PSLRA.

[85]*See* NCC at ¶ 396. Arguments concerning the inadequacy of Plaintiffs' specific allegations of trading by specific individual defendants will be addressed in each defendant's individual brief.

[86] *See* NCC at ¶¶ 397-398.

[87]*See* NCC at ¶ 399.

[88]*See*, *e.g.*, *In re Azurix Corp. Sec. Litig.*, 2002 WL 562819 *21 (S.D. Tex. Mar. 21, 2002); *Branca v. Paymentech, Inc.*, 2000 U.S. Dist. LEXIS 1704, *10-11 (N.D. Tex. Feb. 8, 2000) (conclusory allegations of scienter based upon executive positions, involvement in day-to-day management, access to internal corporate documents, conversations with corporate officers and employees, and their attendance at management and board meetings is not sufficient to plead scienter); *Lirette v. Shiva Corp.*, 27 F. Supp. 2d 268, 283 (D. Mass. 1998) (finding that "inferences that the defendants by virtue of their positions within the company, 'must have known about the problems when they undertook the allegedly fraudulent actions' . . . are precisely the types of inferences which this court, on numerous occasions, has determined to be inadequate to withstand the special pleading requirements in securities fraud cases."); *BMC,* 183 F.Supp 2d at 870, 902 n. 45, 912 n. 40 (same).

3. ENRON'S STATEMENTS CONCERNING WEOS ARE NOT ACTIONABLE AS A MATTER OF LAW.

a. ENRON'S FORWARD-LOOKING STATEMENTS CONCERNING ITS WEOS BUSINESS WERE PROTECTED BY THE PSLRA'S "SAFE HARBOR" PROVISION.

The statements about WEOS that are quoted in the Complaints are not false, nor have Plaintiffs pled <u>facts</u> to show these statements were false. Independent of their truth (which Plaintiffs do not challenge with facts), virtually all of the quoted statements also are not actionable because they come within the "safe harbor" of the PSLRA, which expressly permits companies to make "forward-looking statements"[89] without the threat of liability. *See* 15 U.S.C. 78u-5.

The "safe-harbor" protects forward-looking statements in two respects. First, a complaint must be dismissed to the extent it seeks to impose liability for a "forward-looking statement" that is either: (a) "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statements"; or (b) "immaterial." 15 U.S.C. § 78u-5(c)(1)(A)(i); *see also Wenger.*, 2 F. Supp. 2d at 1241 -42 (N.D. Cal. 1998) (cautionary language need only appear once per presentation or document, not in connection with *each* "forward-looking statement" within a presentation or document). Second, even if there is no cautionary language, the PSLRA requires a plaintiff to prove that the forward-looking statement was made or approved by an executive officer "with actual knowledge by that officer that the statement was false or misleading." *Id.* §§ 77z-2(c)(1)(B), 78-

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[89] 15 U.S.C. § 78u-5(i)(1); (defining forward-looking statements) *see, e.g., Harris v. IVAX Corp.*, 998 F. Supp. 1449, 1453 (S.D. Fla. 1998) (finding the statement "[w]e believe that the challenges unique to this period are behind us" to be a "forward-looking statement" because it was statement that meant "good times are ahead").

5(c)(1)(B); *see, e.g., Harris*, 182 F.3d at 803 ("Even if the forward-looking statement has no accompanying cautionary language, the plaintiff must prove that the defendant made the statement with 'actual knowledge' that it was 'false or misleading'"); *In re The Vantive Corp. Sec. Lit.*, 110 F. Supp. 2d 1209 (N.D. Cal. 2000), aff'd 283 F.3d 1079 (9th Cir. 2000) (same).[90]

i. Enron's Annual Reports Contain Meaningful Cautionary Language Concerning its WEOS Business Within the Protection of the Statutory Safe Harbor.

Enron's statements concerning the future prospects of its WEOS business were accompanied by meaningful cautionary language. 15 U.S.C. § 78u-5(e). While Plaintiffs have not conjured a false statement about WEOS, any allege falsity is immaterial as a matter of law.

As quoted above, Plaintiffs rely on forward-looking statements in Enron's public filings such as: "[The coming year will result in] continued strong growth in the core WEOS business";[91] "Enron [is] setting up for a great fourth quarter and a great 99 in the wholesale business";[92] and "wholesale services ... can be significantly expanded within their very large existing markets and extended to new markets with enormous growth potential."[93] Each of these statements, however, were accompanied by meaningful cautionary language that the Complaints simply ignore. Among other cautionary statements, each of Enron's Annual Reports, contained disclosures *specifically aimed* at its WEOS business:

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[90] Prior to the enactment of the PSLRA's statutory safe-harbor, the SEC had promulgated regulations that protect forward-looking statements under both the Securities Act of 1933 and the Exchange Act of 1934. 17 C.F.R. § 240.3b-6(a); 17 C.F.R. § 240.175(a). These regulations also preclude the imposition of liability for any forward-looking statements that were made in good faith and with a reasonable basis. *Krim v. BancTexas, Inc.*, 989 F.2d 1435, 1447.

[91] NCC at ¶ 197.

[92] NCC at ¶ 119.

[93] NCC at ¶ 293 (citing 2001 10-K).

> Earnings from Enron *Wholesale* are *dependent* on the origination and completion of transactions, some of which are individually significant and which are *impacted by market conditions*, the *regulatory environment* and *customer relationships.... External factors*, such as the amount of *volatility* in market prices, *impact the earnings opportunity associated with Enron Wholesale's* business. Risk related to these activities is managed using naturally offsetting transactions and hedge transactions. *The effectiveness of Enron's risk management* activities can have *a material impact* on future earnings.[94]

These cautionary discussions about WEOS, which were repeated yearly in Enron's public filings, are more than adequate to satisfy the PSLRA's "meaningful cautionary language" requirement for safe-harbor as to all forward-looking countless statements that Plaintiffs cite from Enron's various Form 10-Ks and Form 10-Qs.[95]

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[94] SEC App. Tabs 6, at 53; 10 at 47. *See also* SEC App. Tab 14, at 21 ("Earnings from merchant investments were favorably impacted by a significant increase in the market value of Enron Wholesale's power-related investments, partially offset by the decline in value of investments in certain energy-intensive industries. ... Earnings from these activities result from changes in the market value of the securities."); SEC App. Tab 7, at 20 ("Earnings [from Enron's Wholesale energy assets and investments activities] primarily result from changes in the market value of merchant investments held during the period, equity earnings and gains on sales or restructurings of energy investments."); SEC App. Tab 8, at 22(same); SEC App. Tab 9, at 21 (same); SEC App. Tab 12, at 21 ("Earnings from these activities [investments in debt and equity securities] result from changes in the market value of the security."); SEC App. Tab 13, at 21-22 (same); SEC App. Tab 17, at 21 ("Earnings from these activities [investments in debt and equity securities], which are accounted for on a fair value basis and are included in revenues, result from changes in the market value of the securities."); SEC App. Tab 18, at 21 (same).

[95]For example, Plaintiffs cite Enron's statement in its 2001 Annual Report:

> Enron has built unique and strong businesses that have tremendous opportunities for growth. These businesses – wholesale services, retail energy services, broadband services ... can be significantly expanded within their very large existing markets and extended to new markets with enormous growth potential. At a minimum, we see our market opportunities company-wide tripling over the next five years.

(NCC at ¶ 293 (citing 2001 10-K))

ii. The Statements Concerning WEOS Cited by the Plaintiffs are Protected by the "Bespeaks Caution Doctrine."

As applied, the bespeak-caution doctrine protects forward-looking statements where there was meaningful cautionary language publicly available in the marketplace at the same time. *Trump, 7* F.3d 357 at 371; *see also Grossman v. Novell, Inc.*, 120 F.3d 1112, 1122 (1lth Cir. 1997). Moreover, "courts have not required cautionary language to be in the same document as the alleged misstatement or omission." *Grossman*, 120 F.3d 1112 at 1122 (holding that "cautionary statements contained in registration statement may fairly be considered as limiting the forward-looking predictions made in subsequent discussions of the same transaction"). The cautionary language about WEOS contained in Enron's public filings <u>throughout</u> the alleged class period renders Enron's forward-looking statements about WEOS immaterial as a matter of law.

Like other courts, the Fifth Circuit has recognized the "bespeaks caution" doctrine as a specific application of the broader principle of materiality. *Rubenstein v, Collins, 20* F.3d 160, 168 (5th Cir. 1994). Thus, the Fifth Circuit requires that alleged omissions or misleading "optimistic" statements be read *in conjunction with* cautionary-language in determining whether a reasonable investor would place significant weight on the alleged representation or would assess such statements in light of the disclosed risks. *Id.*; *see also Melder, 27* F.3d at 1100.

Four cases cited favorably by the *Rubenstein* court firmly establish that dismissal as a matter of law would be appropriate based on the existence of meaningful cautionary language:

> Factors such as the specificity of and the extensiveness of the cautionary language are particularly pertinent to this inquiry. *E.g., Krim, 989* F.2d at 1445-49 (cautionary language regarding substantial riskiness of investment and disclosure of approximately $140 million in problem loans made immaterial failure to

> classify as "potential problem loans" $50 million in loans that were 30-89 days overdue); *In re Trump Securities Litig.*, 7 F.3d at 370-77 (specific disclosures of assumptions and industry risks rendered optimistic projections and failure to disclose certain information immaterial as matter of law); *Romani [v. Shearson Lehman Hutton]*, 929 F.2d [875,] 878-79 [(lst Cir. 1991)] (purported omissions not material – defendants extensively disclosed riskiness of investment and specific problems facing industry); *Moorhead [v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.]*, 949 F.2d [243,] 245 [(8th Cir. 199 l)] (feasibility study did not contain an actionable omission or misstatement-- study contained specific cautionary language and risk statements, disclosed underlying economic assumptions).

Rubenstein, 20 F.3d at 168 n.31.

Here, Plaintiffs cite statements such as:

> WEOS had strong growth and a tremendous market franchise with significant sustainable competitive advantages . . . . All of Enron's businesses were generating high levels of earnings. Fundamentals were improving. Enron was <u>very optimistic</u>. Enron was <u>confident growth was sustainable</u> for years to come.[96]
>
> [FY 20]00 would result in:
>
> Continued strong growth in the core WEOS business.
>
> Break-out performance from EES.
>
> Rapid development of EBS.97
>
> On 10/13/98, Enron held a conference call for analysts and investors to discuss Enron's 3rdQ 98 results and its business. During the call, Skilling, Koenig, Causey and Fastow stated:
>
> Enron's news was extremely good. Enron had another excellent quarter.
>
> Everything was going great with Enron. On a very positive note, Enron hedged its investment portfolio and its hedges in the investment portfolio performed extremely well even in uncertain financial markets. Really good news in the finance and investing component. Enron could not state how strong the wholesale business was.

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[96]*See* NCC at ¶ 54; *see also* NCC at ¶ 14(a).

[97]*See* NCC at ¶ 197.

> Enron had a great quarter in the wholesale business. Enron was setting up for a great fourth quarter and a great 99 in the wholesale business.[98]

As set forth in detail above, Enron's 10-Ks and 10-Qs included detailed disclosures of the risks confronting its wholesale business. Plaintiffs do not plead facts to show with any particularity that any statement about WEOS was false. The presence of substantial contemporaneous disclosures of the risks that Enron confronted in its public filings is sufficient to protect these statements under the "bespeaks caution doctrine." *Grossman*, 120 F.3d at 1122. Consequently, the public statements cited by Plaintiffs cannot provide a basis for their claims.

iii. Statements Cited by the Plaintiffs for WEOS are immaterial Puffery.

It is well settled that statements that are "merely expressions of optimism ... too vague to be material" and "more akin to commercial puffery than representations of material facts" cannot therefore constitute fraud.[99] *Calliott v. HFS, Inc.*, No. Civ. A. 3:97-CV-0924-I, 2000 WL 351753 *6, Fed. Sec. L. Rep. 90,939 (N.D. Tex. Mar. 31, 2000) (considering statements that management was "encouraged" or "pleased" with business conditions).

The statements about WEOS cited by Plaintiffs on their face are vague and general optimistic statements that are nothing more than forward-looking and immaterial puffery:

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[98]NCC at ¶ 119.

[99]*See also, e.g., In re MCI Worldcom Sec. Litig.*, -- F.Supp.2d --, 2002 WL 507533 (S.D. Miss. Mar. 29, 2002) (holding that vague, optimistic statements touting "outstanding achievements" "impressive" accomplishments, and "strong" fundamentals, could not, as a matter of law, give rise to securities law violation); *Tuchman*, 14 F.3d at 1069 (quoting *Wright v. International Business Machines Corp.*, 796 F. Supp. 1120, 1126 (N.D. Ill. 1992)) (stating that defendants are under no duty to "'employ the adjectorial characterization'" that plaintiffs believe is more accurate); *San Leandro Emergency Medical Profit Sharing Plan v. Philip Morris Companies, Inc.*, 75 F.3d 801, 805-06, 811 (2nd Cir. 1996) (dismissing claim based, in part, on statement "we are budgeting for and expecting a strong year for all of our businesses").

Enron's wholesale business "provides tremendous competitive advantages";[100] WEOS has "sustainable growth opportunities in each of its markets" and its "competitive position is growing stronger";[101] Enron "continued to be very confident in the prospects for its wholesale businesses."[102]

Plaintiffs allege that the Enron Defendants made misrepresentations to investors by describing their pleasure with results and confidence in projections of Enron's WEOS using terms such as "strong," "excellent," "outstanding," "stunning," and "tremendous."[103] Even if these statements are appropriately ascribed to Defendants,[104] Plaintiffs plead no facts to show they were false -- nor could they. Statements like these are classic corporate "cheerleading." Plaintiffs cannot base a securities fraud claim on a Defendant's statement of contentment with operating results, or by challenging the degree to which particular adjectives expressed those views.[105]

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[100]NCC at ¶ 177.

[101]NCC at ¶ 294.

[102]NCC at ¶ 179.

[103]*See* NCC at ¶¶112, 118, 119, 128, 136, 144, 156, 197, 223, 224, 247, 262, 263, 274, 281, 282, 283, 293, 316, 317, 331, 332, 328, 329, 343, 364, 365, 368; *see also* NCC at ¶¶121(j), 155(o), 214(q), 300(r), 339(r), 359, 390.

[104]As set forth below, insofar as Plaintiffs rely on statements disseminated through analysts' reports, their allegations fail to plead the requisite indicia of reliability upon which to base a fraud claim. *See infra.*

[105]*In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 538 (3rd Cir. 1999) ("Even assuming plaintiffs' allegations are true, the positive portrayals do not contradict any of defendants' other statements but merely report previous successes and express confidence in Advanta's prospects for future growth.").

As just one example, Plaintiffs take issue with statements allegedly made by certain Defendants during an analyst conference in July 2000, claiming that "Skilling, Koenig and Fastow ... stated: ... At the wholesale level, Enron had just a tremendous quarter. Enron felt very good about it, very positive and was optimistic about the outlook for the future. Enron's market position had never been better."[106] This statement is the kind of puffery that this and other courts have repeatedly held to be immaterial because a reasonable investor would not rely on it in making investment decisions. *Cf. In re Azurix Corp. Sec. Litig.*, -- B.R. --, 2002 WL 562819 *19 (S.D. Tex. Mar. 21, 2002) (holding that statements that "fundamentals [we]re strong" was "not actionable because it was too vague to have been relied upon by reasonable investors"); *BMC*, 183 F.Supp.2d at 890 ("[A]llegations about Defendants' indefinite and vague representations that the demand for BMC products was strong or very strong ... are too vague and incomplete to be material or to induce reliance, not to mention being offset by other disclosures."); *Cione v. Gorr*, 843 F.Supp. 1199, 1205 (N.D.Ohio 1994) (holding that representations such as "[we] anticipate continued strong demand for tire products" and "opportunities should expand" fail to contain information of the requisite specificity or indicia of probability such that a reasonable investor would find those statements material to their investment decision).

[106]NCC at ¶247.

B. ENRON IS NOT LIABLE FOR STATEMENTS MADE BY INDEPENDENT STOCK ANALYSTS CONCERNING WEOS.

A large number of the statements about WEOS that Plaintiffs cite were contained in analyst reports published by banking firms that covered Enron.[107] For example, Plaintiffs cite a January 20, 1999 report issued by Merrill Lynch:

> Merrill Lynch issued a report on Enron, rating Enron a "Long-Term Buy," forecasting 99 and 00 EPS of $1.15 and $1.325 and an 18% five-year EPS growth rate for Enron. It also stated:

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[107] *See also* NCC at ¶¶ 120; App. Tab 14, at 1 ("Enron reported third quarter net income of $[0.235] per share ... better than our estimate of $[0.22]. [G]rowth has been spearheaded by sharp gains in Wholesale Energy Operations and Services"); NCC at ¶¶ 123; App.Tab15, at 2 ("Wholesale energy operations ... continued to be the largest contributor to earnings. IBIT was $277 million versus $173 million in last year's third quarter. The strength of the wholesale energy commodity and asset portfolios resulted in excellent earnings."); NCC at ¶¶ 131, App. Tab 17, at 1 ("Wholesale Energy Operations and Services business led the company's growth, achieving record levels ... in earnings."); NCC at ¶¶ 147, App. Tab 19 at 1. ("[Q]uarter-over-quarter operating earnings were up by 5%. The driving force behind this growth was the continued strength of Wholesale Energy Operations and Services."); NCC at ¶¶ 148, App. Tab 20, at 1-2 ("Enron reported 1999 Q-1 income of $253 MM or $[0.34] per share ... above our ... estimate .... Improved performance was driven by continued momentum at Enron Wholesale Services.... Accordingly, we believe longer term earning power should build at attractive rates .... In recent months the relative strength in ENE shares can be attributed to three factors. 1) continued momentum at Enron Wholesale Services 2) rising expectations and valuations for Enron Energy Services (EES), Enron's retail marketing arm, following management's increased expectations for the potential size of the higher margin energy management/outsourcing business, and 3) clarification of the company's strategy and potential in communication and water businesses. As management continues to build on core strengths in these areas we would expect the share price premium to hold."); NCC at ¶¶ 158 App. Tab 50, at 1 ("Wholesale energy marketing remains strong .... We expect continued operating profit growth in the upper end of the 15-20% range."); NCC at ¶¶ 159, App. Tab 22 at 1 ("Impressive gains in the wholesale energy segment and reduced losses in the retail energy segment offset reduced earnings in the transportation and distribution and E&P segments."); NCC at ¶¶ 161, App. Tab 23, at 1 ("We are raising our 1999 and 2000 EPS estimates to $[1.175] and $[1.35] to reflect the stronger quarter and improved prospects across wholesale energy and retail markets."); NCC at ¶¶ 167, App. Tab 50, at 1 "Wholesale energy marketing remains strong .... We expect continued operating profit growth in the upper end of the 15-20% range."); *See also*, NCC at ¶¶ 170 200, 208, 266, 268, 269, 270, 321.

> ENE's diversified strategy is clearly paying handsome dividends. Despite a very difficult 4Q'98 operating environment for energy, ENE posted very respectable results.
>
> * * *
>
> ... Over the next <u>several</u> years <u>we expect</u> annual IBIT growth of nearly 20% in the WEOS business segment alone....
>
> ... Enron Energy Services, should begin to provide more tangible value in 1999.... [T]he sky seems to be the limit for this group. Enron Energy Services is well on its way, as signed contracts of "customers' future expenditures" are now in place for $3.8 billion.[108]

Neither Enron, nor the "Enron Defendants" can be held liable for these forward-looking statements, even if they were not covered by the safe-harbor. Federal securities laws "do not require the company to police statements made by third parties for inaccuracies, even if the third party attributes the statement" to a Defendant. *See Raab v. General Physics Corp.*, 4 F.3d 286, 288 (4th Cir. 1993). To adequately allege that Defendants are responsible for analysts' comments, Plaintiffs would have to plead facts showing that Defendants <u>controlled</u> the contents of those analysts' reports.[109] Here, there simply are no allegations (or facts) sufficient to make such a showing. In the absence of such allegations, statements by independent analysts cannot be attributed to Enron or Defendants as a matter of law.

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[108] NCC at ¶ 130.

[109] *See In re Stratosphere Corp. Sec. Litig.*, 66 F. Supp. 2d 1182, 1199-1200 (D. Nev. 1999) (holding that Defendants are liable only for analysts' reports they "adopt" by entangling themselves with the report through endorsement or approval thereof); Ex. D-9: *In re Health Management Sys., Inc. Sec. Litig.*, No. 97 CIV. 1865(HB), 1998 WL 283286, *5 n.2 (S.D.N.Y. June 1, 1998) ("To adequately plead 'entanglement' plaintiffs must specify what information was supplied to the analyst, who supplied it, and how defendants may have controlled the contents of the report.")

B. ENRON BROADBAND SERVICES

Plaintiffs next plead that Enron committed fraud with regard to Enron Broadband Services ("EBS"). In essence, Plaintiffs' claim with regard to EBS is as follows: Enron, (unlike every other broadband company that failed)[110] foresaw that the entire market for broadband would "melt down." Enron, possessed of its crystal ball, knew this would happen before it even launched Enron Broadband Services. Nevertheless, Enron invested nearly three-quarters of a billion dollars in a broadband business that it knew, all along, would fail. It then "grossly overstated" the prospects for this business by warning investors that the business involved "new technology" in a market that might "never develop." To further conceal its fraud, Enron then revealed to the market that it was sustaining huge losses at EBS, that the market was "melting down," and that it was laying-off employees.

That, in essence, is the nature of Plaintiffs' fraud claim: EBS foresaw what no other company did, invested money it knew would be wasted and then concealed losses that , in fact, it routinely and specifically disclosed. This wholly irrational scenario, as alleged by Plaintiffs, does not support a fraud claim. *See Atlantic Gypsum Co. v. Lloyds International Corp.*, 253 F. Supp. 505, 514 (S.D.N.Y. 1990) (rejecting as irrational RICO claims based on fraud because "on plaintiffs' view of the facts, defendants advanced money to the venture with the intention of driving it into the ground so that they could control the failed venture and then wait in line with other creditors in a bankruptcy proceeding."). Here, as in *Laro, Inc. v. Chase Manhattan Bank*, 866 F. Supp. 132, 137-38 (S.D.N.Y. 1994), there is no "reasonable inference of fraudulent

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[110] Any number of other large broadband companies, such as Level 3 and Global Crossing, also suffered serious business reversals from their own significant—and unprofitable—investments in broadband.

intent" to be drawn from the facts Plaintiffs allege about EBS.[111] Put bluntly, no reasonable investor could have been deceived in light of what Enron disclosed. Plaintiffs' claims with regard to Enron's broadband business must be dismissed.

1. BACKGROUND

Enron Broadband Services was essentially a start-up company within Enron. It was born from a small telecommunications company that Enron acquired as part of Portland General. In January, 2000, Enron renamed the company Enron Broadband Services, "unveiled its communications business,"[112] and announced that this business would now be a core business at Enron. EBS's goal was to become a major player in the new and expanding internet/broadband industry by developing technology and establishing and entering markets that did not exist at the start of the Class Period.

A. BROADBAND INTERMEDIATION

To implement this goal, Enron established two new business centers in EBS. The first was known as "bandwidth intermediation" or "broadband intermediation." Its purpose was to establish a market for trading the bandwidth used to transmit data. Enron's hope was to make use of emerging and nascent technology to make it easier for users of bandwidth to switch suppliers. Once bandwidth users had this freedom, suppliers would compete to supply

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[111] "[S]uch evidence as the plaintiff has pieced together to buttress its theory is outweighed by the reasonable inference that Chase would not intentionally have acted in such a way as to cause itself losses which were enormous even for such a large financial institution...In assessing fraudulent intent, it must be assumed that `the defendant is acting in his or her informed economic self interest'." *Id.* at 138 *quoting Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994).

[112] NCC at ¶ 204.

bandwidth, liquidity would increase, a market would develop, and Enron would then profit from supplying bandwidth and trading in that market. Enron had successfully created similar markets in gas and electricity.

B. BROADBAND CONTENT DELIVERY/VIDEO ON DEMAND

The second business center was known as "broadband content delivery." Enron's goal was to utilize the lower cost and more flexible bandwidth services derived from the new broadband intermediation market to deliver bandwidth intensive services and content such as video more efficiently than in the past. A major part of Enron's broadband content delivery efforts was a July, 2000, contract with Blockbuster to develop the capability to deliver movies to homes on demand. Under that contract, Blockbuster was to provide the content (movies), and Enron was to encode and stream the content over its network. Enron and Blockbuser would jointly select distribution providers who were to provide access and customer service to complete the service package. This effort is sometimes referred to as "video on demand" or "VOD."

C. ENRON WAS A PIONEER.

The market recognized that Enron was entering uncharted cyberspace in these ventures. Plaintiffs' Complaint describe EBS as "unquestionably the pioneer in this market"[113] and as having "invented this market" [114] to "revolutionize the broadband telecommunications industry."[115] The quotes in Plaintiffs' own Complaint refer to Enron's venture with Blockbuster

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[113]NCC at ¶ 204.

[114]NCC at ¶. 234.

[115] NCC at ¶ 234.

as a "major and unique contract"[116] and a "fundamental shift in both the telecommunications and entertainment industries."[117] EBS was by its very nature a "forward looking" company.

D. EBS SUFFERED LOSSES FROM THE START.

Like most start-up companies involved with the internet, EBS suffered losses. Enron made no secret of those losses. While Plaintiffs' Complaint refers to profits from various other divisions, Enron's references to EBS were primarily to its future "potential,"[118] its "progress,"[119] and its massive and growing losses:

> Broadband Services reported a loss before interest, minority interests and taxes for the first half of 2000 of $8 million.[120]
>
> Broadband Services recognized a loss before interest, minority interests and taxes of $20 million in the third quarter of 2000.[121]
>
> Broadband Services reported a loss before interest, minority interests and taxes for the first nine months of 2000 of $28 million.[122]
>
> Broadband Services recognized a loss before interest, minority interests and taxes of $60 million in the year 2000.[123]
>
> Broadband Services recognized a loss before interest, minority interests and taxes of $35 million in the first quarter of 2001.[124]

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[116]NCC at ¶ 243.

[117]NCC at ¶ 248. The *Tittle* Plaintiffs also noted that EBS's contact with Blockbuster was the "first-of-its-kind." (TCC at ¶227).

[118]*E.g.*, NCC at ¶. 212.

[119]*E.g.*, NCC at ¶ 294.

[120]*See* SEC App.Tab 13, at 27.

[121]*See* SEC App. Tab 14, at 23.

[122]*See* SEC App., Tab 14, at 29.

[123] *See* SEC App., Tab 15, at 44.

Broadband Services recognized a loss before interest, minority interests and taxes of $102 million for the first half of 2001.[125]

Like countless other businesses, Enron had invested those losses in new "dot.com" technology in the hope of great future returns. Unfortunately, the information superhighway turned out to be a much tougher road than Enron (or just about any of the other companies on it) expected.

E. BOTH OF EBS'S BUSINESS CENTERS FOUNDER.

i. Content Delivery Was Starved by Lack of Content.

Enron performed a successful test of its technology with a limited number of titles in December, 2000. Blockbuster was responsible for delivering the movies and, as Plaintiffs themselves admit, "[w]hen Enron tried to convince Hollywood to grant Blockbuster the right to distribute digital video content, Hollywood refused. EBS never succeeded in persuading Hollywood to grant Blockbuster the requisite content rights."[126] In March, 2001, less than eight months after Enron announced the video on demand venture with Blockbuster, Enron announced that it was terminating the deal because, while Blockbuster had digital distribution rights to enough movies for the test market, it was not able to get movies for commercial development. As Plaintiffs acknowledge in their Complaint:

> Enron Corp. . . . said Blockbuster didn't provide the "quantity and quality" of movies needed to drive the service. . . . "We were able to obtain some content which was adequate for the trial but wouldn't be enough when we move forward

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[124] *See* SEC App., Tab 17, at 23.

[125] *See* SEC App. Tab 18, at 23.

[126] NCC at ¶ 300(o) and 339(o).

on a commercial basis," said Kelly Kimberly, senior vice president of Enron's Broadband Services unit.[127]

Less than two weeks later, Enron confirmed that it would "redeploy 200-250 employees at its Enron Broadband unit."[128] Enron attempted to obtain the digital movie rights directly from the studios, but by July, 2001, Enron's CEO disclosed that it had experienced "a difficult quarter in our broadband business" and that it was "significantly reducing our broadband cost structure to match the reduced revenue opportunities currently available."[129] Plaintiffs' Complaint acknowledges that Enron disclosed at that time that "Enron's focus going forward would be in the intermediation area" as opposed to content delivery.[130]

ii. The Broadband Intermediation Market Evaporated.

Enron's efforts to develop a vibrant broadband market fared no better. Although Enron made progress toward developing a market and engaged in some trades, and, even by Plaintiffs' allegations, laid "thousands of miles of fiber optic cable and purchased the rights to thousands of additional miles of fiber,"[131] by late 2000[132] "a debate on Wall Street [developed] as to whether

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[127]NCC at ¶ 301.

[128]*See* App. Tab 33 at 1.

[129]NCC at ¶ 328.

[130]NCC at ¶ 329.

[131]NCC at ¶ 475; *see also* NCC at ¶ 520.

[132] Plaintiffs allege that it "became clear that there was a glut of broadband capacity" in "mid-00." (NCC at ¶ 594). If that were true, then the CNNfn interviewer that Plaintiffs quote in their Complaint would not have been asking Mr. Skilling three months later if it was "a fantasy" that "we might actually be entering a broadband glut." (NCC at ¶ 264).

we might actually be entering a broadband glut."[133] Enron candidly and publicly admitted that such a glut was "a very real possibility" and that Enron planned to try to use the ability to trade real-time bandwidth to take advantage of that glut.[134] But the glut that Wall Street thought it might be entering in late 2000 was more severe than anyone had dared to fear. The price didn't just decline, the market itself evaporated as the counterparties with whom Enron hoped to trade became uncreditworthy. Conditions in the internet and telecommunications industry were generally deteriorating in the first part of 2001, and by April, 2001, analysts following Enron noted "recent turmoil and negative investor psychology in the tech/telecom marketplace."[135] By mid-2001, conditions had worsened dramatically. In July, 2001, Enron's CEO admitted that "[i]ndustry conditions in the broadband area are very weak, to say the least. . . . People are not contracting, and to the extent they're contracting, prices are extremely, extremely low, and they're taking a long time to decide if they want to do anything. . . I mean, Carl, *there's a meltdown out there*, and the problem that you have that we didn't have in the electricity business or the gas business when we were developing it, and this problem has just recently occurred, is there are not credit-worthy counter parties in the business. . . . . Yes, I think that's fair to say that just the revenue pie in broadband has shriveled."[136]

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[133]NCC at ¶ 264.

[134]NCC at ¶ 264.

[135] NCC at ¶ 54, 321.

[136]App. Tab 38, at 7, 15, 27. In August, 2001, CEO Lay also acknowledged that EBS's "single biggest problem has been the shortage of creditworthy counterparties ...." (TCC at ¶ 329). Whether Enron could have revived broadband intermediation trading after the market revived is a question that will likely go unanswered in light of Enron's bankruptcy.

F. ENRON TOOK CHARGES AGAINST EARNINGS.

On October 16, 2001, a little over a year and a half after EBS was named, Enron reported a $180 million charge "associated with the restructuring of Broadband Services, including severance costs, loss on the sale of inventory and an impairment to reflect the reduced value of Enron's content services business."[137] Enron also reported a charge of $544 million related to losses associated with certain investments [including] broadband and technology investments.[138] Less than a week later, Mark Newby filed his complaint in this Court.

G. PLAINTIFFS ARE USING 20/20 HINDSIGHT.

To be sure, EBS faced technological hurdles just as any "pioneer" in any new industry would, but those hurdles were not the reason for its failure. The entire industry went from the next great thing in mid-2000 to "might actually be entering a broadband glut" in October, 2000, to "meltdown" by mid-2001. Put simply, Plaintiffs complain that, unlike everyone else in the industry, Enron must have foreseen the future and committed fraud when it failed to disclose that future to its shareholders. They make this claim, moreover, in the face of Enron's conceded investment of nearly a *billion* dollars to "*lay* thousands of miles of fiber-optic cable and *purchase* [] the rights to thousands of additional miles of fiber." NCC at ¶ 26.

Plaintiffs' allegations are nothing more than "fraud by hindsight." Enron did not foresee that the broadband market would melt down or that Blockbuster would be unable to fulfill its commitment to secure movies for video on demand. EBS failed; it did not defraud.

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137 NCC at ¶ 364; TCC at ¶ 274.

138 NCC at ¶ 364; TCC at 274.

2. PLAINTIFFS' COMPLAINT[139]

A. PLAINTIFFS RELY UPON THE CONTENT OF ANALYSTS' REPORTS OVER WHOM ENRON IS NOT EVEN ALLEGED TO HAVE HAD INVOLVEMENT OR CONTROL.

The vast majority of Plaintiffs' allegations regarding EBS are from analysts' reports. The *Newby* Plaintiffs rely upon such reports in no fewer than 50 paragraphs of their Complaint.[140] Plaintiffs have wholly failed to allege that Enron or any of the individual Defendants had any involvement in or control over the content of those analysts' reports.[141] Of course, a defendant cannot be held accountable for a statement over which he has no control. *In re BMC*, 183 F.Supp.2d at 871 n.21.

B. PLAINTIFFS' RELIANCE UPON PUFFING WAS PROHIBITED EVEN BEFORE THE PSLRA.

In the face of Enron's undisputed disclosure of its massive cash investment and of massive losses in EBS, Plaintiffs are left to rely upon vague statements of optimism or "puffery" to support their fraud claim. Plaintiffs cite statements such as "Enron Broadband Services is off to a tremendous start,"[142] "opportunities are enormous,"[143] "we're going to change the whole

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[139] The *Newby* Complaint addresses EBS and related issues in paragraphs 2, 3, 6, 14, 36, 39, 40-41, 54, 122, 142-143, 197, 204-8, 211-15, 217, 223, 224, 226-7, 229, 231-4, 237, 240-52, 254-55, 257-58, 261, 263-65, 267-68, 270, 276, 281-2, 284, 285, 287, 293-4, 300-4, 306-11, 314, 316, 317, 320-23, 327-29, 331, 335, 337-9, 361, 364, 368, 395-7, 418, 423, 426, 475, 497, 520-33, 535, 546-8, 586, 588, 594-5, 604, 631-9. The *Tittle* Complaint addresses some but not all, of the same allegations regarding EBS and related issues in paragraphs 195, 196, 198, 218, 222, 227, 229, 233, 236, 237, 239, 252, 257-259, 266, 269, 274, 366-378.

[140] NCC at ¶¶ 204-209, 211-213, 226, 227, 229, 231-234, 237, 242-244, 248-52, 254, 255, 257, 258, 265, 267, 268, 270, 284, 285, 287, 301-304, 306-308, 310, 320-323, 327, 335, 338. The *Tittle* Plaintiffs also inappropriately relied upon analyst's report. TCC at ¶ 218.

[141] *See infra* at Section VI.A. (Analyst and Press Reports).

[142] NCC at ¶ 215.

entertainment experience for the average American over the next few years,"[144] "[c]ustomer reception is strong"[145] and EBS is "looking good."[146]

Even before adoption of the PSLRA, courts dismissed fraud allegations that were based on vague and general optimistic statements or on projections of future performance that are not worded as guarantees. In the Fifth Circuit's recent decision in *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 419 (5^{th} Cir. 2001), the Court stated, "it is well-established that generalized positive statements about a company's progress are not a basis for liability." Similarly, in *In re BMC Software*, this Court stated:

> Vague, loose optimistic allegations that amount to little more than corporate cheerleading are 'puffery,' projections of future performance not worded as guarantees, and are not actionable under federal securities law because no reasonable investor would consider such vague statements material and because investors and analysts are too sophisticated to rely on vague expressions of optimism rather than specific facts.

183 F.Supp.2d at 888 (citing *Krim*, 989 F.2d at 1446). Since the enactment of the PSLRA, the SEC's safe-harbor rules provide additional barriers to lawsuits premised on unspecific, unquantifiable statements of optimism and projections. *Id.*

In *Grossman v. Novell, Inc.*, 120 F.3d 1112 (10th Cir. 1997), the plaintiffs alleged that Novell fraudulently represented that it experienced "'substantial success' in integrating the sales forces" of the two companies, that the merger of the two companies "'was moving faster than we

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[143]NCC at ¶ 217.

[144]NCC at ¶ 241.

[145]NCC at ¶ 213.

[146]NCC at ¶ 309. The *Tittle* Plaintiffs also rely heavily on statements found in Enron's press releases or newsletters that qualify as puffery or puffing comments in interviews or speeches given by management. TCC at ¶¶ 221, 227, 229, 233, 236, 237, 239, 252, 257, 259, 266, 269.

thought,'" and that the two companies were "'moving rapidly to a fully integrated sales force.'" 120 F.3d at 1121-22. The *Grossman* court affirmed the dismissal of the action, stating "[t]hese are the sort of soft, puffing statements, incapable of objective verification, that courts routinely dismiss as vague statements of corporate optimism." *Id.*[147]

Similarly, in *In re BMC Software*, this Court dismissed securities fraud allegations that were premised on BMC's statements

> [t]hat integration of newly acquired Boole & Babbage and New Dimension was *proceeding well* and would not interfere with BMC's achieving forecasted results; *that business was performing better than expected* and that BMC enjoyed strong demand for its mainframe software; that BMC had a *stellar quarter with very strong demand* for its core products; that Defendants were comfortable with analysts' earnings expectations five weeks prior to the end of a quarter; that Defendants *had overcome problems that caused poor results in the previous quarter* and announced BMC was 'in so much better shape' with the worst behind.

183 F.Supp.2d at 904. BMC subsequently did a complete about-face, and announced adverse results for the company which sent its stock "plummet[ing]" by close to 50%. 183 F.Supp.2d at 869, 878, 904. Nonetheless, management's general references to the company's past and current performance, and its future prospects were not actionable. 183 F.Supp.2d at 891-92, 916-17; *see also In re Peritus Software Services, Inc.*, 52 F. Supp. at 219-20 (statement that the company was experiencing "'unprecedented market demand'" for its products was "mere corporate puffery").

[147]*See also In re Peritus Software Servs., Inc. Sec. Litig.*, 52 F. Supp. 2d 211, 27-29 (D. Mass. 1999) (statement that the acquisition and integration of another company had been a "success" was puffery).

c. THE RISKS ASSOCIATED WITH INVENTING NEW MARKETS WAS DISCLOSED IN ENRON'S FILINGS AND KNOWN TO THE INVESTING PUBLIC.

Plaintiffs' reliance upon puffing statements is especially inappropriate in this case. "[T]he securities laws presume that skilled investors are aware that a corporation's performance with a new product or in a new market is unlikely to replicate past successes." *In re Verifone Securities Litigation*, 784 F. Supp. 1471, 1484 (N.D. Ca 1992); *see also In re Trump Casino*, 7 F.3d at 369-70 *cert. denied sub nom. Gollomp v. Trump*, 510 U.S. 1178, 114 S.Ct. 1219, 127 L.Ed.2d 565 (1994). Enron was not merely introducing a new product or entering an established market, it was inventing the markets it planned to enter. The risks of such innovation are a matter of common sense, and they were also fully disclosed in Enron's public filings.

D. PLAINTIFFS CANNOT RELY UPON UNSUPPORTED CONCLUSIONS AND ANONYMOUS SOURCES TO SUPPORT THEIR CLAIM.

Plaintiffs rely upon anonymous sources to support conclusory statements that EBS's broadband system was "a complete fiction,"[148] that the software Enron proposed to use initially was "a non-sensical component around which to build the product,"[149] and that Enron's representation that its network "'currently connects to most major U.S. cities' was a lie."[150] Plaintiffs similarly rely upon an unspecified "12/00 internal EBS document"[151] and a variety of dramatic but unattributed quotes about, *inter alia*, alleged coup attempts and poisoned Kool-

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[148]NCC at ¶ 633.

[149]NCC at ¶ 633.

[150]NCC at ¶ 635.

[151]NCC at ¶¶ 300(k) and 339(k).

Aid.[152] In addition to being flawed for their lack of particularity, such conclusory statements from anonymous sources fail to plead fraud with particularity and have been rejected because the PSLRA requires plaintiffs to plead "the sources from which plaintiffs obtained [their alleged] information." *Coates*, 26 F.Supp.2d 910 (cited with approval in *BMC*); *see also In re Technical Chemicals Securities Litigation*, 2001 WL 543769 at *4 (S.D. Fla., March 20, 2001) (plaintiffs' reliance on allegations by unnamed scientists did not meet the particularity requirements under the PSLRA, because "in order to plead facts with particularity, a plaintiff must provide a list of all relevant circumstances in great detail."); *In re Silicon Graphics Inc. Sec. Lit.*, 183 F.3d 970, 984-85 (9th Cir. 1999).

E. PLAINTIFFS FAIL TO ALLEGE THAT MOST OF THE STATEMENTS CITED IN THEIR COMPLAINT ARE FALSE.

The allegations relating to EBS suffer from another pervasive pleading defect: Namely, Plaintiffs fail to connect their allegedly "true facts" to any of the alleged representations in the preceding section of their brief. So while Plaintiffs quote a lot of statements, they fail to allege with any particularity that most of them are false. Plaintiffs' Complaint cites various statements about broadband by "Enron" and analysts who followed Enron in three of the six time periods addressed in the Complaint. At the conclusion of each time period, Plaintiffs allege that "each of the statements between [various dates] was false and misleading when issued."[153] Plaintiffs then allege "true but concealed facts," the first of which is the general "fact" that "[t]he purported

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[152]NCC at ¶¶ 300(o), 339(o). The *Tittle* Plaintiffs also attempt to rely upon anonymous sources to support their claims related to Project Braveheart. TCC at ¶¶ 374, 375. Such statements fail under Rule 9(b).

[153]NCC at ¶¶ 214, 300, 339.

prospects for, and actual success of, Enron's EBS division was [sic] grossly overstated."[154] Plaintiffs then state, and twice repeat, a laundry list of "true but concealed facts" that are not tied to the representations previously alleged. As noted earlier, this exact approach, by these same Plaintiffs' counsel, has been repeatedly rejected. But even if this method of pleading were permitted, it should be rejected in this case, because both Plaintiffs' general allegations about EBS and Plaintiffs' laundry list that purportedly supports the general allegations fail to meet the requirements of Rule 8, Rule 9(b) and the PSLRA.

F. PLAINTIFFS' GENERAL ALLEGATIONS THAT BOTH EBS'S PROSPECTS AND SUCCESS WERE OVERSTATED FAIL UNDER THE PSLRA.

Plaintiffs' general allegations that "the purported prospects for, and actual success of, Enron's EBS division was [sic] grossly overstated"[155] cannot withstand scrutiny.

i. Plaintiffs' Allegation of Grossly Overstated Prospects for EBS is a Forward Looking Statement Protected Under the PSLRA Safe Harbor and the Bespeaks Caution Doctrine.

Plaintiffs' allegation that Enron overstated "the purported prospects for . . . EBS" is flawed on its face. Aside from being too general to support a securities fraud claim, any statement of the "purported prospects" for EBS was, by its very nature, a forward looking statement. Such statements fall squarely within the safe harbor provided by the PSLRA.

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[154]NCC at ¶¶ 214(h), 300(h) and 339(h). Plaintiffs' factual allegations relating to EBS fail under Rule 9(b) because, *inter alia*, they do not identify the speaker, state when and where the statements were made and explain why the statements contained within each factual allegation were fraudulent. (TCC at ¶¶ 218, 219, 221, 222, 227, 229, 233, 236, 237, 239, 252, 257-9, 266, 269).

[155]*E.g.*, NCC at ¶¶ 214, 300, 339. The *Tittle* Plaintiffs make analogous general allegations about EBS, and they are equally flawed when examined under Rule 9(b). (TCC at ¶¶ 196, 258, 366).

> The safe harbor protects individuals and corporations from liability for forward-looking statements that prove false if the statement is "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement" or where the forward-looking statement is immaterial. 15 U.S.C. §78u-5 (c)(1)(A)(I) and (ii). If a statement is "accompanied by meaningful cautionary statements," the defendants' state of mind is not relevant.

In re BMC, 183 F. Supp. 2d at 881 n.28. Even before the PSLRA, such statements were protected by the "bespeaks caution" doctrine. Under the bespeaks caution doctrine, the inclusion of meaningful cautionary language in forecasts, opinions, and projections, render alleged omissions or misrepresentations immaterial as a matter of law. *Parnes,* 122 F.3d at 548.[156] In *Parnes*, the defendants issued a new product line of computers, and warned investors that "'[t]here can be <u>no assurance</u> that these products or features will be successful.'" 122 F.3d at 549. The Eighth Circuit affirmed the district court's dismissal of the complaint, and stated:

> In light of <u>this explicit cautionary statement</u>, no reasonable investor could have been misled that Gateway's new portable products, which represented a small fraction of Gateway's total sales, were anything but a risky venture.

Id. (affirming dismissal and denial of leave to amend).

Here, Enron gave substantially greater warnings to the public than the "no assurance" language that has been held sufficient for dismissal under the PSLRA. Enron entered into the broadband services market for the first time at the end of 1999. In the first Form 10-K following its market entry, Enron not only cautioned investors about its ability to penetrate the broadband

[156]Drawing upon Fifth Circuit precedent, this Court has previously noted that "public warnings about risk factors affecting [BMC's] prospects, contained in public filings, stock analysts' reports, and conference calls," rendered BMC's alleged misstatements immaterial. *BMC*, 183 F. Supp. 2d at 888, 895 (describing the "bespeaks caution" doctrine). *See also Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 9 (2d Cir. 1996); *Atkins v. Hibernia Corp.*, 182 F.3d 320, 326 (5^{th} Cir. 1999) (cited in *BMC*).

market, but warned that such market might not develop at all. Enron specifically cautioned investors:

> INFORMATION REGARDING FORWARD LOOKING STATEMENTS
>
> This Annual Report includes forward-looking statements . . . . Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and *no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include . . . the ability to penetrate the broadband services market . . . .*"[157]

Enron did not stop there. In that same 1999 Form 10-K, Enron further warned:

> Development of bandwidth as a commodity will be dependent, among other things, on the ability of the industry to develop and measure quality of service benchmarks and connectivity of networks of market participants to facilitate processing of contracted services. *There can be no assurance that such a market will develop.*[158]

Enron repeated its original warning over and over again in 2000:

> INFORMATION REGARDING FORWARD LOOKING STATEMENTS
>
> This Quarterly Report on Form 10-Q includes forward-looking statements. . . . Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and *no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include . . . the ability to penetrate the broadband services market . . . .*[159]

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[157]SEC App.Tab10, at 56.

[158]SEC App. Tab 10, at 17.

[159]SEC App. Tab 12, at 25.

INFORMATION REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes forward-looking statements. . . . Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and *no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include . . . the ability to penetrate the broadband services market . . . .*[160]

INFORMATION REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes forward-looking statements. . . . Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and *no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include . . . the ability to penetrate the broadband services market . . . .*

SEC App. Tab 14, at 33. In its 2000 Form 10-K, Enron warned:

INFORMATION REGARDING FORWARD LOOKING STATEMENTS

This Report includes forward-looking statements. . . . Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and no *assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include . . .* development of Enron's broadband network and customer demand for intermediation and content services. . .

SEC App. Tab 15, at 52. Enron further warned:

Development of bandwidth as a commodity will be dependent, among other things, on the ability of the industry to develop and measure quality of service benchmarks and connectivity of networks of market participants to facilitate processing of contracted services. *There can be no assurance that such a market will develop.*

[160]SEC App. Tab 13, at 31.

> *Id.* at 16; and
>
> Enron provides premium broadband delivery services for media and entertainment....There can be no assurances that a broadband market will develop for premium broadband delivery services.[161]

Enron's use of cautionary language regarding its new business brings it within the protections of the PSLRA's safe harbor and the bespeaks caution doctrine. Plaintiffs' claims should be dismissed.

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161 Enron repeated the following warning in its 10Qs filed for the first two quarters of 2001:

> INFORMATION REGARDING FORWARD LOOKING STATEMENTS
>
> This Report . . . . includes forward-looking statements. Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and *no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include . . . development of Enron's broadband network and customer demand for intermediation and content services . . .*
>
> SEC App. Tab 17, at 29.
>
> INFORMATION REGARDING FORWARD LOOKING STATEMENTS
>
> This Report . . . . includes forward-looking statements. Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and no *assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include . . . development of Enron's broadband network and customer demand for intermediation and content services . . .*
>
> SEC App. Tab 18, at 34.

ii. PLAINTIFFS' GENERAL ALLEGATION THAT ENRON OVERSTATED THE ACTUAL SUCCESS OF EBS ALSO FAILS.

Plaintiffs' allegation that the "actual success of, Enron's EBS division was grossly overstated," is belied by the actual results Enron reported for its EBS division. As noted above, Enron reported losses for EBS from the start.

In its June 2000 Form 10-Q, Enron stated:

> Broadband Services reported a loss before interest, minority interests and taxes for the first half of 2000 of $8 million.[162]

The *Newby* Complaint acknowledges that Enron disclosed, and analysts warned, that the loss would have been higher but for a nonrecurring gain from the sale of dark fiber.[163] The *Newby* Plaintiffs also acknowledge that analysts knew that EBS only broke even in its first quarter of 2000 *because* of the dark fiber sale.[164]

Just three months later, even as the number of contracts being signed rose, Enron reported even greater losses:

> *Broadband Services recognized a loss* before interest, minority interests and taxes of $20 million in the third quarter of 2000.[165]
>
> In case any investor missed the prior Form 10-Q, Enron also reported EBS' losses thus far for the year:
>
> *Broadband Services reported a loss* before interest, minority interests and taxes for the first nine months of 2000 of $28 million.[166]

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[162]SEC App. Tab 13, at 27.

[163]NCC at ¶¶ 251 and 252 ("Included in these figures was a $50 million non-recurring gain from the sale of dark fiber assets during the quarter.").

[164]NCC at ¶¶ 226 and 231.

[165]SEC App. Tab 14, at 23.

[166]*Id.* at 29.

In its next public filing in December 2000, in reporting on EBS' first year of operations, Enron revealed still worse losses:

> *Broadband Services recognized a loss* before interest, minority interests and taxes of $60 million in 2000.[167]

These disclosures coupled with the widely known rapid "burn rate" of many internet companies in 2000,[168] put any investor on notice that EBS had not yet experienced great success.

The losses continued in 2001. Enron's March, 2001, public filing showed that EBS recognized a loss before interest, minority interests and taxes of $35 million.[169] That same month, Enron announced the termination of the Blockbuster venture and confirmed to analysts that it would "redeploy 200-250 employees at its Enron Broadband unit,"[170] prompting some in the industry to speculate about EBS's content on delivery demise.[171]

As if that were not enough, in June, 2001, Enron told the world that EBS recognized a loss before interest, minority interests and taxes of *$102 million.*[172] Enron also projected that worse was yet to come:

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[167]*See* SEC App. Tab 15 at 44.

[168]Enron had no duty to advise potential investors of industry trends that were already commonly known, such as the industry-wide burn rate that dominated 2000. *See, e.g., Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1246 (N.D. Cal. 1998) ("A company cannot be held liable for failing to educate the public about publicly known facts."); *Raab v. General Physics Corp.*, 4 F.3d 286, 290-91 (4th Cir. 1993) (misrepresentation was immaterial where market generally had knowledge of adverse conditions).

[169]*See* SEC App. Tab 17, at 23.

[170]*See* App. Tab 33, at 1.

[171]NCC at ¶ 321.

[172]SEC App. Tab 18, at 23.

> Enron is significantly modifying the cost structure of Broadband Services to correspond to *slower market development* and the associated *lower revenue outlook.*
>
> *Enron expects losses to continue through at least 2001 in the Broadband Services segment.* Future profitability is dependent on the recovery of the broadband and communications sectors.
>
> *Gross margin decreased $82 million* in the second quarter of 2001 compared to the second quarter of 2000. *Weak market conditions* in the broadband and communications sectors negatively impacted the 2001 gross margin.[173]

By July, 2001, Enron was "hyping" the broadband business by telling analysts that the industry conditions were "very weak, to say the least," that "[p]eople are not contracting, and to the extent they're contracting, prices are extremely, extremely low," that recently "credit-worthy counterparties" had disappeared from the business, that the business had "melt[ed] down" and that the "revenue pie in broadband has shriveled."[174] No reasonable investor, faced with a claim by Enron's CEO that its business had "melted down," could have concluded anything *other* than that EBS faced the prospect of continued significant *losses* in this business. The statements that Plaintiffs claim "grossly overstated"[175] Enron's prospects in fact, did the opposite. Taken in context, they certainly were not material to *a reasonable* investor. Indeed, it is difficult to imagine how Enron could have made the present or the future for EBS sound much worse.

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[173] *Id.,* at 22-23.

[174] *See* App. Tab 38, at 7, 11, 15, 27.

[175] NCC at ¶ 214(h), 300(h) and 339(h).

G. PLAINTIFFS' "LAUNDRY LIST ALLEGATIONS" THAT PURPORTEDLY SUPPORT PLAINTIFFS' GENERAL ALLEGATION REGARDING EBS ALSO FAIL UNDER THE PSLRA.

None of the "true but concealed facts" alleged in Plaintiffs' laundry list can withstand scrutiny either. The first item in Plaintiffs' laundry list is that Enron's EBS division faced technical difficulties that foreclosed any hopes of financial success or a functioning broadband network.[176] Plaintiffs make no effort to tie those allegedly concealed facts to the statements of analysts or statements of Enron officers quoted in the Complaint, but they point to the following "examples" of the allegedly "numerous and intractable problems."

i. EBS's InterAgent Allegedly Failed.

Plaintiffs' first "intractable problem":

> For EIN [Enron Intelligent Network] to work, Enron had to build 20 pooling points internationally and 30 in the U.S. Measuring data flow at the pooling points required something known as inter-agent messaging and InterAgent – the software that was to make the intelligent network operational – became the core of EIN. But InterAgent had to "speak" to hardware from various different manufacturers, such as Cisco and Sun, which it could not do. Since InterAgent failed, EIN would fail as well.[177]

Plaintiffs cite to no person, document, or source of any kind for their allegation that InterAgent had to "speak" to hardware from various manufacturers or that it could not do so, but most importantly, Plaintiffs also cite no support for the notion that "[s]ince InterAgent failed, EIN would fail as well." The success of the EIN was not dependent upon InterAgent. In fact, as

[176]NCC at ¶ 214(h), 300(h) and 339(h).

[177]NCC at ¶ 214(i), 300(h) and 339(h).

of February, 2000, it was known in the industry that Enron was not using InterAgent, but was in fact using Lucent and Nortel technology to operate the EIN, which was up and running.[178]

ii. EIN Allegedly did not Work.

Plaintiffs' second "intractable problem":

> To create InterAgent, Enron had acquired a company called Modulus. From the outset there was no way Modulus could create a viable InterAgent program because it was simply too small (three employees) to undertake a project of such magnitude. By spring 99, the development of the EIN had "*deteriorated into chaos*." The problems in building the EIN did not improve during 99. By 10/99, EBS was "*in crisis mode*," and Rice, CEO of EBS, realized that EIN was a disastrous failure.[179]

This allegation suffers from the same problems as Plaintiffs' first intractable problem, and more. First, Plaintiffs' anonymous quotations that the "EIN had 'deteriorated into chaos' by the Spring of 1999" and "was 'in crisis mode'" by October, 1999, ignores the fact that *EBS was not launched until January, 2000.* Prior to that time, EBS was not a core Enron business, but rather a company that Enron had received as part of the purchase of Portland General and to which Enron had assigned a value of "a full zero."[180] Again, Plaintiffs cite to no source for these supposed facts or for the supposed fact that EIN was a "disastrous failure."[181] As Enron explained to the world in February, 2000, problems with InterAgent were not "intractable" as

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[178]*See* App. Tab 27, at 5; *see also* App. Tab 39, Slide AC_00_Communications-21.

[179]NCC at ¶ 214(i), 300(h) and 339(h).

[180]App. Tab 49, at 2.

[181]Plaintiffs' allegation that "Rice, CEO of EBS, realized that EIN was a disastrous failure" by October, 1999, (NCC at ¶ 399(h)) is not only unsupported and false; it cannot be reconciled with their allegation that Rice "was Chairman and Chief Executive Officer of EBS *since 6/00*." (NCC at ¶ 83(h)).

Plaintiffs claim, because Enron was able to get the EIN up and running using technology from Lucent and Nortel.[182]

iii. EBS Allegedly Lacked Customers In 1999.

Plaintiffs' third "intractable problem":

In fact, "EBS did not have a single real customer in 1999."[183]

This allegation ignores that EBS was not launched or called EBS until January, 2000. Further, Plaintiffs' Complaint points to no statement by anyone at Enron claiming that EBS *had* a single customer in 1999, let alone explains why any claimed customer was "unreal."

iv. Plaintiffs Accuse EBS of Doing Business with Companies that did Business with EBS.

Plaintiffs' fourth "intractable problem":

> While Enron extolled the number of orders and users it had for its network, the truth was that "the sales staff could not sell what the engineers could not build, and the engineers could not build what the sales staff had promised." Consequently, a "blend-and-extend" trick was introduced. EBS sales representatives were told to sell anything now – get customers to place any order no matter how small (and move delivery into next year) – and, in return, Enron would place a larger order to buy something from the customer. For instance, Real Networks gave Enron a $100,000 order, but Enron gave a $7 million purchase order to Real Networks for software.[184]

Plaintiffs do not attempt to date this allegation or say who "extolled the number of orders or users [Enron] had for its network," how or where they extolled it, or to whom those unidentified people "extolled" it. Plaintiffs allege that EBS sales representatives "were told to sell anything now," but they do not disclose when "now" was, or who at Enron supposedly told

[182]*See* App., Tab 27, at 5; *see also,* App. Tab 39, at 21.

[183]NCC at ¶ 214(i), 300(h) and 339(h) (emphasis in original).

[184]NCC at ¶ 214(i), 300(h) and 339(h).

them to do so. Plaintiffs also claim that "Real Networks gave Enron a $100,000 order, but Enron gave a $7 million purchase order to Real Networks for software," but again they fail to say when this supposedly happened, who was involved, or why there is anything wrong with Enron accepting an order from Real Networks or purchasing software from Real Networks, or even that the two transactions were connected.

Plaintiffs' allegation that "the sales staff could not sell what the engineers could not build and the engineers could not build what the sales staff had promised," suffers from the same defect. Namely, the Complaint fails to allege what the sales staff had promised or why the engineers could not build it.

v. EBS Allegedly Accepted Small Orders from Companies with Which It Did Business.

Plaintiffs' fifth "intractable problem":

> Enron trumpeted high-profile customers, including Inktomi, Microsoft and Real Networks, as proof that EBS was a genuine broadband provider. But these small $100,000 deals represented favors by Microsoft and Real Networks to Enron in exchange for orders by Enron in 99,worth as much as $7 million (in at least one other case). Enron frequently paid larger amounts to vendors in exchange for much smaller orders.[185]

While still not providing any specific dates, Plaintiffs allege that the "blend and extend" transactions where Enron engaged in the remarkably-common business practice of doing business with those who did business with it, occurred in "99." This was, of course, before EBS was launched. Plaintiffs fail to identify any order that was given as a favor. Plaintiffs also fail to allege where Enron "trumpeted" its high profile customers, who at Enron blew the trumpet, or who heard it.

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[185]NCC at ¶ 214(i), 300(h) and 339(h).

vi. EBS's Powerpoint Slides Were True; Plaintiffs' Allegations About Them are not.

Plaintiffs' sixth "intractable problem":

> Indeed, the 1/00 analyst presentation about EBS was a study in how to lie with Power Point slides: "Current" lines on a U.S. map purportedly showed *actual* fiber-optic lines, but, in truth, EIN was *all dark*, i.e., non-functional, at the end of 99; "pending" indicated lines under construction, but most were not in substantive development; and where a map purported to show the ECI South America network under development, in fact, *there was never anything under construction in South America*. These claims were untrue – the broadband group was already in "*crisis management mode*."[186]

Plaintiffs do not provide the "U.S. map" on which they purport to rely or describe it with any particularity, but the relevant slide from that meeting never uses the word "current" and says nothing about "pending" or whether the fiber is lit or dark. It states simply "Fiber Owned and Contracted."[187] Plaintiffs do not allege that there was not fiber owned and/or contracted in the places indicated on that map. Plaintiffs' allegation that Enron somehow concealed the fact that at least some of its fiber was dark is also belied by statements quoted elsewhere in Plaintiffs' Complaint.[188]

Plaintiffs' allegation about a map that "purported to show the ECI South America network under development" is also demonstrably false. Again, Plaintiffs do not provide the map on which they purport to rely and the maps from the January, 2000, analyst conference show nothing akin to what Plaintiffs allege. Contrary to any representation at the meeting that South America was currently under development, EBS's Ken Rice said at the meeting, "And

[186]NCC at ¶ 214(i) (all emphasis in original).

[187]App. Tab 39, at Slide AC_00_Communications-15.

[188]NCC at ¶ 250 (On 7/24/00 and 7/25/00, Merrill Lynch reported "EBS is on track to have <u>lit by year end</u> [2000] 14,500 miles of fiber.")

right now we're on two continents and we'll be extending to Asia and South America *over the next year or so*."[189]

vii. EBS Allegedly Swapped Inactive Fiber.

Plaintiffs' next three "true but concealed facts" all allege that Enron entered into dark fiber swaps at artificially high prices to "inflate the purported revenue of its EBS operations."[190] Plaintiffs do not allege that there is anything wrong with swapping dark fiber and, of course, it is the logical way to increase the coverage of one's network without huge capital expenditures. Plaintiffs' Complaint acknowledges that Enron disclosed that it was engaging in dark fiber swaps and the "sale of excess dark fiber to balance capacity in the region."[191] With respect to their claim that the trades were done at artificially inflated prices, Plaintiffs fail to allege when the inflated swaps were done, or what the true prices were, or what affect the alleged inflation had on the revenue of EBS. The only date or dollar amount Plaintiffs mention is to allege that in the "3rd Q 00" Enron "booked a dark fiber deal with LJM worth over $300 million," but that deal was not a swap[192] and, again, Plaintiffs fail to allege the terms of the deal or what revenue was (or should have been) reported on it.[193]

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[189]App. Tab 39, at 14.

[190]NCC at ¶ 214(k), (l), 300(i), (j), and (j)(i) and 339 (i), (j), and (j)(i).

[191]NCC at ¶ 281.

[192]*See* SEC App. Tab 15, at 96.

[193]In another section of their Complaint, Plaintiffs claim that "swaps and trades were made with Dynegy, Williams, El Paso, Metromedia Fiber, Acrie Networks, Qwest, Level 3, 360 Networks, and Touch America, among other players," but Plaintiffs do not say whether these trades were "improper" dark fiber swaps or at what price the swaps should have been recorded. (NCC at ¶ 529). The only dark fiber deal for which Plaintiffs provide any detail at all is one that allegedly took place on September 30, 2001, less than two weeks before Newby filed his first complaint,

viii. EBS Allegedly Made Unprofitable Trades.

Plaintiffs allege that Enron concealed the "true fact" in that it "boasted about its high and increasing volume of broadband trades, but these purported trades were not profitable."[194] Plaintiffs fail to allege who at Enron "boasted about its high and increasing volume of broadband trades," where they boasted about them, who at Enron said that those trades were profitable or who heard them say it. With respect to profits, there can be no dispute that EBS reported losses throughout its existence. In fact, Plaintiffs fail to identify a single statement by anyone at Enron that any broadband trade <u>was</u> profitable to Enron.

ix. EBS Employees Allegedly Complained about Their Bosses.

Plaintiffs' next "concealed fact" is a melodramatic account of an alleged "coup attempt:"

> The situation in EBS was so desperate by Spring 01 that there was a coup attempt by several managers who reported to CEO Rice and COO Hannon and wanted them moved out of EBS. The managing directors met with Skilling and informed him that EBS was in extremely dire straits – there was "*no way to win*," EBS "*had no income*," and the "*cash-burn rate was too high*." They showed Skilling actual EBS performance numbers. Rejecting their request, Skilling neither replaced Rice and Hannon nor did he make any changes, other than having the managing director also now report to him directly to keep him updated on the disaster in EBS.[195]

Plaintiffs' allegation, while vivid, fails to provide any of the specificity required by Rule 9(b) or the PSLRA, such as who made the anonymous statements Plaintiffs quote, or who was

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and even for that deal Plaintiffs fail to state what price was assigned to the dark fiber in the deal or what price should have been assigned. (NCC at ¶ 529). The *Tittle* Plaintiffs only refer to one dark fiber sale in passing, making the general allegation that Enron was "manufacturing earnings by selling dark fiber optic cable to LJM2" but providing no detail. TCC at ¶ 313.

[194]NCC at ¶¶ 300(j)(ii),339(j)(ii).

[195]NCC at ¶ 300(j)(iii) and 339(j)(iii).

involved in the "coup attempt," or who the managing director was that would now report directly to Skilling to keep him updated on the "disaster in EBS."[196] Plaintiffs' allegation suffers from the additional defect that Skilling and the rest of the world knew there were problems at EBS and specifically that its "cash-burn rate was too high."[197] It was that very month that Enron announced the termination of the Blockbuster venture and said that it would "redeploy 200-250 employees at its Enron Broadband unit."[198]

As evidenced by the "redeployments," in March, 2001, Enron knew it faced challenges, but it also had reason for hope, with respect to both intermediation and content delivery. While the Blockbuster deal had failed because, as Plaintiffs acknowledge, Blockbuster had failed to obtain content from the studios, Enron hoped to obtain the content directly. As the Complaint acknowledges, the studios did not want to grant digital rights, and just three months later, Enron announced that as opposed to content delivery, Enron's focus going forward would be in the intermediation area.[199] On the intermediation side, Enron hoped to benefit from trading on the price decline as it had when it developed the electricity and gas markets, but that hope was dashed when creditworthy counterparties disappeared.[200]

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[196]While Plaintiffs' suggest in the "true but concealed facts" that "the managing directors met with Skilling and informed him that EBS was in extremely dire straits" as part of a coup attempt in March, 2001, Plaintiffs allege in another section of the brief that it was <u>Skilling</u> who traveled to Portland in March, 2001, and "stated that the broadband business faced a 'complete meltdown.'" NCC at ¶ 311.

[197]As noted above, high cash-burn rates for broadband companies were no secret.

[198]*See* App. Tab 33, at 1.

[199]NCC at ¶ 329; *see* SEC App. Tab 18 at 22.

[200]*See* App.Tab 38 at 7, 15, 27.

x. EBS's CEO Allegedly, At Some Point, Publicly Reported an Estimate of the Value of EBS's Assets.

Plaintiffs complain that "[d]espite EBS's failed operations, EBS CEO Rice publicly stated that broadband's assets had an estimated value of $36 billion."[201] Plaintiffs then quote an unnamed "high-ranking former EBS manager - one of the very first broadband employees" as responding, "I don't know what metric he was looking at. We were well into the business by then and in the process of flopping."[202] Plaintiffs do not say when Rice is alleged to have revealed that estimate, what disclosure he gave of the methods and assumptions underlying any such estimate or why -- when made -- this "estimate" was misleading. Plaintiffs also fail to allege whether this estimate was before or after Blockbuster failed to deliver the content required for video on demand, or before or after Enron's potential counterparties for broadband intermediation became uncreditworthy and the market melted down. Such factors make the timing of the alleged estimate critical and the deficiency in Plaintiffs' pleading fatal.

xi. Enron Allegedly Lied About How Many Customers And Transactions It Had.

Plaintiffs allege that "[a]t the 1/00 Conference Enron claimed it had 16 million customers."[203] Plaintiffs' unspecified allegation is even more troubling because the transcript of the "1/00 Conference" submitted with this brief contains no statement at all about any "16 million customers."[204] This allegation suffers from a lack of specificity. It also suffers from a

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[201] NCC at ¶ 300(j)(iv) and 339(j)(iv).

[202] NCC at ¶ 300(j)(iv) and 399(j)(iv).

[203] NCC at ¶¶ 300(k) and 339(k).

[204] App. Tab 49.

lack of veracity. Of equal significance, Plaintiffs do not say who made this statement or what exactly was said. Plaintiffs also do not disclose whether the person who allegedly made this representation said these were actual customers or merely potential customers. Given that the "1/00 conference" to which Plaintiffs refer was the conference where Enron launched EBS as a new business, it is unlikely that Enron would have claimed, or any analyst would have believed, that EBS was born with 16 million customers -- and the transcript refutes this allegation entirely.

As proof that the "16 million" figure that Plaintiffs say Enron claimed was false, Plaintiffs point to an unspecified "12/00" "internal EBS document."[205] Plaintiffs do not say who of the hundreds of people in EBS wrote this unspecified document and, as noted above, reliance upon such "anonymous sources" has been rejected by a number of courts.[206]

Thus, without any specificity, Plaintiffs have alleged that some unnamed person at Enron made a statement that appears nowhere on the transcript of the meeting -- that Plaintiffs next assert was false because some unidentified document purportedly contains some unspecified contradictory statement. Allegations like these are the reason for Rule 8, Rule 9(b) and the PSLRA.

Plaintiffs also claim that Enron "grossly overstated" the number of broadband intermediation customers it had and the number of trades it conducted.[207] Plaintiffs claim that Enron did this by splitting trades into smaller pieces and counting trades with "experimental"

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[205]NCC at ¶¶ 300(k) and 339(k).

[206]*Cf. In re Azurix,* 2002 WL at 13 (noting that "Plaintiffs also fail to explain who these 'former employees' are who confirmed plaintiffs' allegations of fraud. . .")

[207]NCC at ¶¶ 300(m) and 339(m).

customers.[208] Plaintiffs fail to identify a single intermediation trade that was not properly recorded, or a single "experimental" customer that was, but should not have been, claimed by Enron. Even if it is assumed that trades should not be broken into smaller pieces and that "experimental" customers should not be counted and even if Plaintiffs identified one or more such trades, Plaintiffs' claims against the Individual Defendants still fail. Plaintiffs allege only that "management" was well aware of and even encouraged this practice, but they fail to identify who in "management" was aware of these practices or gave such instructions or how they became aware of them.[209]

xii. Enron's Prospects for Future Revenue and Profitability were Allegedly "Completely Arbitrary."

Plaintiffs allege that it was "true but concealed" that:

> The prospects for future revenue and profits from Enron's EBS operation and the purported value to Enron and to its stock price was completely arbitrary and without any basis in fact because Enron knew from *current* problems in that business, as well as the current state of the EBS business, that such revenue and profit forecasts and valuations were arbitrary, unreasonable, and unobtainable.[210]

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[208] Plaintiffs only identify one broadband intermediation trade which they say was to provide broadband services to a German University affiliated with Rice. While Plaintiffs do not allege that the trade itself was illegitimate or unprofitable, they complain that the accounting for that trade was improper and that it only closed because Mr. Lay donated $5 million to Rice University. NCC at par. 300(n)(ii) and 339(n)(ii). Plaintiffs do not allege any facts to support any connection between the two events.

[209] Plaintiffs claim Enron misused mark-to-market accounting and that the "trade value never made sense." (NCC at ¶¶ 300(m) and 339(m)). Plaintiffs claim that "assumptions on different variables were tweaked" to make the returns higher on trades and that this together with improper mark-to-market accounting created inappropriately higher current period revenue and bottom line results. (NCC at ¶¶ 300(m), (n) and (n)(i) and 339(m), (n) and (n)(i)). Plaintiffs fail to identify any broadband intermediation trade that did not make sense, any assumption or any variable that was tweaked, what the appropriate assumption or variable should have been, or how mark-to-market accounting was misapplied. Plaintiffs' allegations in this regard and their allegations of abuses of mark-to-market accounting are also addressed in II G, *supra*.

[210] NCC at ¶ 214(l), 300(l) and 339(l) (emphasis in original).

Plaintiffs do not identify what "purported value to Enron and its stock price" they are talking about, when that purported value was calculated, who calculated it, or what the proper value should have been. This allegation could not be less particularized and it cannot support a claim of any kind.

xiii. Plaintiffs Allege that Enron's Entire Blockbuster Deal was a Fraud.

Relying again upon anonymous sources, Plaintiffs claim that "'the Blockbuster deal was a fraud, and Enron's top management knew it.'"[211] As support for this allegation, Plaintiffs first point out that "Blockbuster did not have the legal right to electronically distribute movie content - the indispensable element of a successful broadband based VOD system - in cable quality digital format."[212] Plaintiffs' allegations admit that Enron disclosed *from the start* that this was "*a first-of-its-kind agreement*"[213] and Plaintiffs point to no suggestion anywhere that Enron could have known that Blockbuster would not fulfill its part of the bargain to obtain the right to supply the content for Enron to transmit. Plaintiffs acknowledge that Enron terminated the arrangement for that reason.[214]

Plaintiffs further claim that the Blockbuster venture was a fraud because when Enron signed the deal, its network "could not then - and probably never would be able to - deliver VOD

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[211]NCC at ¶ 300(o) and 339(o).

[212]NCC at ¶ 300(o) and 339(o).

[213]NCC at ¶ 40.

[214]NCC at ¶¶ 41 and 339.

as represented by Enron."[215] Plaintiffs purport to base this conclusion upon the fact that Ken Rice allegedly told two unnamed EBS engineers whom he was trying to recruit that "we [Enron] can't deliver the Blockbuster deal."[216] Plaintiffs provide no further context for the statement and do not even allege whether the two unnamed engineers agreed to come back to EBS. It is difficult to imagine how Mr. Rice could have thought it would help to recruit talent to announce to them that Enron could not fulfill a major contract.

Plaintiffs point to anonymous quotations for the proposition that Enron did not currently have all it needed to perform under the Blockbuster contract. Plaintiffs point to nothing at all for the conclusion that Enron could not develop or acquire the talent and technology needed to perform under the contract. A major contract like Blockbuster in this industry could be expected to require the hiring of additional talent to develop or refine the necessary technology. If taken as true, Plaintiffs' allegation actually demonstrates that EBS was recruiting these anonymous engineers to ensure that Enron *could* perform the Blockbuster contract.

When Enron announced the Blockbuster venture in July, 2000, it disclosed that its plan was to "introduce the service in multiple cities by year end" and Plaintiffs themselves admit that by the end of 2000, "there were . . . test systems in four cities."[217] Plaintiffs claim that in the test marketing Enron loaded "40 movies on to a Sun Server" and "[a] set-top box was required and it

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[215]NCC at ¶¶ 300(o) and 339(o).

[216]Given that Plaintiffs admit that video on demand could not succeed without the content Blockbuster was to provide, any alleged deficiencies in Enron's technology could not have caused the failure of content delivery and are, therefore, irrelevant.

[217]NCC at ¶¶ 40, 41, 524; *see also* TCC at ¶ 371.

was a far cry from VOD for anything in Blockbuster's inventory as had been promised."[218] The requirement of a set top box has not prevented the proliferation of cable, and as noted above, Enron cannot be blamed for Blockbuster's failure to deliver content. Plaintiffs have failed to point to any insuperable technical problem that would have prevented Enron from moving forward if Blockbuster or the studios had been willing to provide the needed content.

3. ACCOUNTING FOR THE BLOCKBUSTER TRANSACTION AND PROJECT BRAVEHEART

Plaintiffs allege that Enron "misuse[d]" and "abuse[d]" mark-to-market accounting to "secretly record[]" and "improperly report" profits on its contract with Blockbuster.[219] Plaintiffs claim in some places that those profits were $11 million[220] and elsewhere that they were more than $100 million.[221] Plaintiffs are unable to point to any documents or statements that reflect the alleged abuse and misuse of mark-to-market accounting for this transaction, and they do not attempt to allege how the transaction should have been recorded. In fact, not only did Enron not "misuse" or "abuse" mark-to-market accounting in connection with that transaction, Enron did not use mark-to-market accounting on that transaction at all. Project Braveheart, which resulted in those profits, was actually recorded and reported pursuant to FAS 140.[222]

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[218]NCC at ¶ 524.

[219]NCC at ¶ 41; *see also* TCC at ¶ 372.

[220]NCC at ¶¶ 300(o) and 339(o).

[221]NCC at ¶¶ 40 and 521.

[222] The *Tittle* Plaintiffs make similar complaints about accounting for Project Braveheart, particularly the use of mark-to-market accounting. TCC at ¶¶ 258, 259, 366, 372-76 and 546. The *Newby* Plaintiffs also complain generally about the use of mark-to-market accounting for intermediation transactions. NCC at ¶ 546. With the single exception addressed in footnote 209,

Plaintiffs allege that the "improper" accounting was somehow facilitated by an investment by CIBC for which CIBC supposedly got some sort of "secret[] . . . no-loss guarantee" from Enron. Plaintiffs do not allege the date of this "secret" guaranty, who at Enron gave it to whom at CIBC, or any of the "secret" guaranty's terms. Moreover, Plaintiffs admit that this secret, unspecified, guaranty was never enforced.[223]

Finally, Plaintiffs complain that after the Blockbuster venture failed, "Enron did not reverse the huge profits."[224] But Enron did reverse those profits just a few months later, and it would not have been appropriate to recognize any losses sooner, because, *inter alia* Enron was still attempting to secure content directly. Enron explained at the time it terminated the contract with Blockbuster that it intended to secure content itself."[225] When those efforts did not bear fruit over the next few months, Enron reversed the very profits about which Plaintiffs complain.

4. EBS CONCLUSION

EBS was essentially a start up company with two business centers. Broadband intermediation failed because Enron lacked creditworthy counterparties with whom to trade. In other words, due to the "tech wreck" in 2001, almost everyone else in that business went broke, depriving the market of trading participants. Video on demand failed because, as Plaintiffs admit,

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Newby Plaintiffs do not identify any allegedly improper use of mark-to-market accounting for intermediation trades and, in fact, mark-to-market accounting is the required method for accounting for such transactions.

[223]NCC at ¶ 41 ("CIBC did not force Enron to honor its secret guarantee against losses.").

[224]NCC at 41; see also NCC at ¶¶ 521-26. The *Tittle* Plaintiffs, while acknowledging that Enron did book the reversals, allege that Enron should have dealt with them earlier. TCC at par. 378. Given that Enron was attempting to secure content directly during mid-2001, it would not have been appropriate to recognize those losses any sooner.

[225]See App., Tab 73, 4/18/01, J.P. Morgan Report.

Blockbuster could not get the rights to the movies for Enron to deliver. Enron did not and could not have predicted either of those events, and it did not commit fraud in failing to do so.

C. PLAINTIFFS FAIL TO STATE ANY ACTIONABLE CLAIMS IN CONNECTION WITH THE OPERATION OF ENRON ENERGY SERVICES, ENRON'S COMMERCIAL ENERGY UNIT.

Plaintiffs focus a portion of their claims against the Enron Defendants on a unit of Enron engaged in the sale of power and related management services to large commercial outlets, Enron Energy Services (EES). Plaintiffs claim that Enron issued misleading statements about the success of EES generally and about the nature of the contracts that it entered with various purchasers of its services specifically. Plaintiffs further claim that Enron inaccurately accounted for the revenues which EES contracts generated and improperly inflated these revenues in violation of certain applicable accounting doctrines. Because Plaintiffs fail to gather in one location in their repetitive and bloated complaints the allegations they make regarding EES, the claims lack a cogency essential to understand and evaluate them. *See, e.g., In re Secs. Litig. BMC Software Inc.,* 183 F. Supp. 2d 860, 886 (S.D. Tex. 2002); *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1244 (N.D. Cal. 1998).

In large measure, Plaintiffs point to statements about EES that are not actionable because they are either puffery or because they fall within doctrines protecting forward-looking statements. In number, Plaintiffs burden the reader with over 100 of these clearly non-actionable statements regarding EES. In addition, Plaintiffs claim a series of material omissions regarding the structure and content of certain EES contracts and the accounting treatment given these contracts, all of which are belied by Enron's public releases, which are properly cognizable at this stage and which we describe in detail. What is left of Plaintiffs' claims of fraud in the operation of EES are a series of generalized rants that are devoid of particularity and insufficient under the rigorous doctrines imposed on Plaintiffs by Rule 9(b) and the PSLRA. In fact, Plaintiffs' claims are so general that they fail even to place Defendants on notice of what they must defend. *See* Fed. R. Civ. P. 8.

1. PLAINTIFFS' EES CLAIMS ARE HEAVILY BASED ON STATEMENTS THAT ARE NOT ACTIONABLE BECAUSE THEY ARE FORWARD LOOKING OR ARE MERE PUFFERY.

Generalized optimistic statements about a company's future prospects—puffery—are immaterial as a matter of law.[226] Courts are particularly reluctant to find that expressions of general optimism are material in cases such as this one, where reliance is premised on a "fraud on the market" theory, because "[t]he market may well take a more jaundiced view of corporate statements ... than an individual investor." *Phillips v. LCI Int'l., Inc*, 190 F.3d 609, 617 (4th Cir. 1999).

The bulk of Plaintiffs' claims involving EES, at least measured by volume and verbiage, constitute references to statements that are puffery by any analysis. Plaintiffs allege, for example, that Enron made generally optimistic statements of its beliefs about EES' prospects. *See e.g.* NCC at ¶ 197 ("EES has had a watershed year"); at ¶ 128 ("We have experienced a strong market reception and very successful contracting results"); and at ¶ 177 ("Enron Energy Services has been building a strong sales and execution team to capture a lead position in the U.S. retail

[226] *See e.g., Nathenson*, 267 F.3d at 419 ("[I]t is well established that generalized positive statements about a company's progress are not a basis for liability."). *See also Kurtzman.* at 51-56; *In re Waste Management*, at 123, n.42, 170-71; *Lain v. Evans*, 123 F. Supp. 2d 344, 348 (N.D. Tex. 2000); *McNamara v. Bre-X Minerals Ltd.*, 57 F. Supp. 2d 396, 414 (E.D. Tex. 1999).

energy market."). Statements remarkably similar to these, and to others listed by Plaintiffs,[227] have been routinely dismissed as puffery by the courts. *See e.g. Greebel v. FTP Software, Inc.*, 194 F.3d 185, 189,207 (1st Cir. 1999)(statements that "[w]e are pleased with our performance for the second quarter" and that "[s]ales continue to be strong" are puffery).[228] The result should not differ here.

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[227] The *Tittle* Plaintiffs make similar complaints about accounting for Project Braveheart, particularly the use of mark-to-market accounting. (TCC at par. 258, 259, 366, 372-76 and 546). The *Newby* Plaintiffs also complain generally about the use of mark-to-market accounting for intermediation transactions. (NCC at par. 546). With the single exception addressed in footnote 208, *Newby* Plaintiffs do not identify any allegedly improper use of mark-to-market accounting for intermediation trades and, in fact, mark-to-market accounting is the required method for accounting for such transactions.

[228] *See also See Nathenson,* 267 F.3d at 419 (defendants' promises that their new drug is "fast acting" and an "improved formulation" is "nothing more than inactionable puffing" and therefore "cannot support plaintiffs' claim."); *Lasker v. New York State Elec. & Gas Corp.*, 85 F.3d 55, 57-59 (2d Cir. 1996) (statements that company is "convinced our business strategies will lead to continued prosperity" and that its "1994 sales goal is the most aggressive ever" are puffery); *Hillson Partners Ltd. Partnership v. Adage, Inc.*, 42 F.3d 204, 212, 216-17 (4th Cir. 1994) (statements that "significant sales gain should be seen as the year progresses;" "1992 will produce excellent results;" company is "on target toward achieving most profitable year in its history;" and company "should have an excellent fourth quarter" are puffery); *Raab v. General Physics Corp.,* 4 F.3d 286, 289-90 (4th Cir. 1993) (statements that company "expected annual growth of 10% to 30% over the next several years" and "was poised to carry growth and success of 1991 well into the future" are puffery); *Waste Management* at 170-71 (puffery "include[s] generalized nonspecific statements of historical fact"); *Lain,* 123 F. Supp. 2d at 348 (statements that "we look forward to higher revenues and loan volume for the remainder of fiscal 1998" and "have aggressive growth plans . . . to become a major player" are puffery); *In re Browning-Ferris Indus. Inc. Secs. Litig.*, 876 F. Supp. 870, 885-86, 897 (S.D. Tex. 1995) (statements that "the future prospects of our solid waste collection and disposal business are extremely attractive" and that "the future of the Company looks bright" were "mere puffery"); *Fitzer v. Security Dynamics Tech., Inc.,* 119 F.Supp.2d 12, 23 (D.Mass. 2000) (holding that "[t]he corporate puffery rule applies to loose optimism about both a company's current state of affairs and its future prospects."); *In re Syntex Corp. Sec. Litig.,* 855 F.Supp. 1086, 1095 (N.D.Cal. 1994) (statements that "[w]e expect the second half to be stronger than the first," and that "[n]ew products are coming in a wave not in a trickle . . . [and] [o]ld products are doing very well" were "nothing more than 'puffing,' which reasonable investors know do not guarantee future success."). The *Tittle* Plaintiffs also imply that CIBC's investment in Project Braveheart was

Those statements that are not pure puffery are nonetheless immaterial because they are mere predictions of uncertain events. Plaintiffs begin with an attack on a statement that EES' "earnings for the business are expected to be positive," NCC at ¶ 128, continue with observations that "EES expects to meet or exceed its target," NCC at ¶ 177, and end with an express forecast, "Enron was forecasting strong profits for the full year 00." These, like the other Enron predictions cited by Plaintiffs[229] are just that: predictions. Predictions of uncertain future events that are not worded as guarantees are not actionable under the securities laws, *see* 15 U.S.C. Section 78u-5(c)(1)(A); *see also Kurtzman*, slip op. at 51-52; *Waste Management*, slip op. at 170-71, or under any common law theory, either.

Plaintiffs nevertheless go on to lard their complaint with paragraph after paragraph of analysts' predictions about EES.[230] Plaintiffs nowhere allege, however, the facts required to attribute these statements to any defendant other than the analysts who wrote them. *In re* BMC, 183 F.Supp.2d at 872, n.21 ("[T]here must be alleged facts showing some involvement in and control over the content of the analysts' reports by the defendants to hold [the defendants] liable for misleading statements made in those reports."). Even if these statements were attributable to other defendants, and they are not, the analysts' reports on which Plaintiffs rely suffer from the

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somehow improper, yet they fail to allege how it was improper, except to contend that some anonymous person at Enron both "promised' and "guaranteed" to return CIBC's investment, while never identifying who gave such a promise or what its terms were and never alleging that any such repayment was made. (TCC at par. 368, 369).

[229] *See* NCC at ¶¶ 120, 123, 125, 127, 128, 130, 131, 133, 176, 177, 179, 184, 197, 224, 248, 284. The *Tittle* Plaintiffs, while acknowledging that Enron did book the reversals, allege that Enron should have dealt with them earlier. (TCC at par. 378). Given that Enron was attempting to secure content directly during mid-2001, it would not have been appropriate to recognize those losses any sooner.

[230] See NCC at ¶¶ 120, 125, 127, 176, 184, 248, 284.

same defects: They are all forward-looking statements that are not legally actionable. Statements such as CIBC's that "The division is expected to turn profitable...", NCC at ¶ 120, or Lehman Brothers' observations about "the expectation that Enron Energy Services will swing to EBIT positive by the fourth quarter," NCC at ¶ 125, are purely forward looking and do not create a cause of action. The same is true of statements such as "future retail contracts are growing," NCC at ¶ 120, or "the sky seems to be the limit," NCC at ¶ 130. These statements are simply immaterial as a matter of law.

Importantly, the immaterial nature of the forward-looking statements about EES is not altered by the fact that some of them contain information about current EES contracts or financial results. Rather, as this Court ruled in *Kurtzman*, "[w]here a review of the entire statement, beyond an isolated line or phrase, demonstrates that it is a mixed statement, containing both historical observations and prognostications based on those observations, the entire statement qualifies as forward-looking for safe harbor purposes." *Kurtzman*, slip op. at 86. As the Eleventh Circuit explained in *Harris v. Ivax,* 182 F.3d 799, 806 (11th Cir. 1999), "forward–looking conclusions often rest both on historical observations and assumptions about future events. Thus, were we to banish from the safe harbor lists that contain both factual and forward-looking factors, we would inhibit corporate officers from fully explaining their outlooks." *Accord In re Republic Serv., Inc. Sec. Litig.,* 134 F. Supp. 2d 1355, 1363 (S.D. Fla. 2001); *In re Unicapital Corp. Sec. Litig.,* 149 F. Supp. 2d 1353, 1374 (S.D. Fla. 2001); *In re Champion Enterprises, Inc. Sec. Litig.,* 144 F. Supp. 2d 848, 860-61, 863-64, 864-65 (E.D. Mich. 2001). Thus, even the paragraphs of the *Newby* and *Tittle* Complaints that allege statements about EES followed by projections are not actionable.

Importantly, Enron consistently cautioned potential investors about uncertainties and risks associated with its retail business activities. These consistent public warnings of risk factors specific to EES render any potentially actionable misrepresentations and omissions immaterial as a matter of law. For instance, in its first 10-K[231] following the establishment of EES in May, 1997, during which Enron reported EES losses, Enron also warned investors as follows:

> INFORMATION REGARDING FORWARD LOOKING STATEMENTS
>
> This Annual Report includes forward looking statements... Although Enron believes that its expectations are based on reasonable assumptions, it can give no assurance that its goals will be achieved. *Important factors that could cause actual results to differ materially* from those in the forward looking statements herein *include ... the ability to penetrate new retail natural gas and electricity markets in the United States and Europe.*[232]

In each 10-K and 10-Q between November 1998 and November 1999, during which EES continued to report losses, Enron repeated warnings regarding the risk factors associated with its retail business. Each report cautioned potential investors that "[a]lthough Enron believes that its expectations are based on reasonable assumptions, it can give no assurance that its goals will be achieved. Important factors that could cause actual results to differ materially from those in the forward looking statements herein *include...ability to penetrate new retail natural gas and electricity in markets in the United States and Europe; the timing and extent of deregulation of energy markets in the United States and in foreign jurisdictions; other regulatory developments*

[231]SEC App. Tab 2, at 62.

[232]SEC App. Tab 6, at 70.

in the United States and in foreign countries, including tax legislation and regulations; *the extent of efforts by governments to privatize natural gas and electric utilities and other industries*."[233]

> Once EES turned profitable, in 2000 and 2001, Enron expanded its caution to investors regarding its future expectations for that retail business to include its risk management activities:

INFORMATION REGARDING FORWARD-LOOKING STATEMENTS

> This (Annual/Quarterly) Report includes forward-looking statements... All statements other than statements of historical facts contained in this document are forward-looking statements. Forward-looking statements include, but are not limited to, statements relating to...growth in the demand for retail energy outsourcing solutions. When used in this document, the words 'anticipate,' 'believe,' 'estimate,' 'except [*sic*],' 'intend,' 'may,' 'project,' 'plan,' 'should' and similar expressions are intended to be among the statements that identify forward-looking statements. Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include...<u>the ability of Enron to penetrate new retail natural gas and electricity markets (including energy outsourcing markets) in the United States and Europe;... the timing and extent of deregulation of energy markets in the United States and in foreign jurisdictions; other regulatory developments in the United States and in foreign countries, including tax legislation and regulations; the extent of efforts by governments to privatize natural gas and electric utilities and other industries; the timing and extent of changes in commodity prices for crude oil, natural gas, electricity, foreign currency and interest rates</u>; the extent of success in acquiring oil and gas properties and in discovering, developing, producing, and marketing reserves;...<u>the effectiveness of Enron's risk management activities; the ability of counterparties to financial risk management instruments and other contracts with Enron to meet their financial commitments to Enron</u>;... and Enron's ability to access the capital markets and equity markets during the periods covered by the forward-looking statements, which will depend on general market conditions and Enron's ability to maintain or increase the credit ratings for its unsecured senior long-term debt obligations."[234]

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[233]*See* SEC App. Tabs 5, at 41; 6, at 70; 7, at 31; 8, at 40; 9 at 38.

[234] *See* SEC App. Tabs 10, at 56-57; 15, at 52-53; 12, at 25; 13, at 30-31; 14, at 33; 17, at 29; 18, at 34.

Even in its final 10-Q during the Class Period, Enron continued to caution investors about the EES risk management activities of which Plaintiffs complain:

INFORMATION REGARDING FORWARD LOOKING STATEMENTS

This Report and the Form 10-K include forward-looking statements... All statements other than statements of historical facts contained in these documents are forward-looking statements. *Forward-looking statements include, but are not limited to, statements relating to...extension of Enron's business model to new markets and industries, transaction volumes in the U.S. power market. . .growth in the demand for retail energy outsourcing solutions,*. . .effectiveness of Enron's action plan for restructuring its businesses including restructuring scheduled maturities of debt and other obligations and other efforts to assure adequate liquidity. When used in this document, the words 'anticipate,' 'believe,' 'estimate,' 'expects,' 'intend,' 'may,' 'project,' 'plan,' 'should' and similar expressions are intended to be among the statements that identify forward-looking statements. Although Enron believes that its expectations reflected in these forward-looking statements are based on reasonable assumptions, such statements involve risks and uncertainties and no assurance can be given that actual results will be consistent with these forward-looking statements. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include ...; *the effectiveness of Enron's risk management activities*; willingness of counterparties to engage in financial risk management and other contracts with Enron without requiring collateral for obligations or increasing existing collateral requirements; the ability of counterparties to financial risk management instruments and other contracts with Enron to meet their financial commitments to Enron; and Enron's ability to access the capital markets and equity markets during the periods covered by the forward-looking statements, which will depend on general market conditions and Enron's ability to maintain the credit ratings for its unsecured senior long-term debt obligations; success in marketing natural gas and power to wholesale customers; the ability of Enron to penetrate new retail natural gas and electricity markets (including energy outsourcing markets) in the United States and foreign jurisdictions; *the timing, extent and market effects of deregulation of energy markets in the United States, including the current energy market conditions in California, and* in foreign jurisdictions; other regulatory developments in the United States and in foreign countries, including tax legislation and regulations;...*the extent of efforts by governments to privatize natural gas and electric utilities and other industries*; the timing and extent of changes in commodity prices for crude oil, natural gas, electricity, foreign currency and interest rates...." SEC Tab 19, at 73.

These cautionary statements render immaterial all the forward-looking statements alleged by the Complaint to be false and misleading.[235]

2. THE REMAINING ALLEGATIONS REGARDING EES IN THE NEWBY AND TITTLE COMPLAINTS DO NOT CONSTITUTE ALLEGATIONS OF FRAUD PLED WITH PARTICULARITY AND DO NOT RAISE A STRONG INFERENCE OF SCIENTER.

Shorn of their reliance on puffery and protected forward-looking statements, the *Newby* and *Tittle* complaints are quite limited in their references to EES. The remaining allegations neither plead fraud as to EES with particularity nor establish a strong inference of scienter as to the Enron Defendants in connection with any EES activity.

A. ENRON MADE EXTENSIVE DISCLOSURES ABOUT EES BUSINESS PRACTICES.

Plaintiffs have purported to plead a series of facts regarding core EES business activities that were allegedly concealed. These are: (a) costs that Enron and EES were obligated to incur in connection with the contracts which EES negotiated with its customers and (b) the use of mark-to-market accounting as the means of booking income generated by the contracts EES negotiated. These allegations belied by Enron's disclosures and by the very accounting guidance on which Plaintiffs purport to rely in claiming that Enron violated General Accepted Accounting Principles (GAAP).

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[235]Where, as here, Plaintiffs allege fraud on the market, "the relevant inquiry concerns the total mix of information available to the market at the time of the allegedly fraudulent statements," without regard to which particular documents contain that information." *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1122 (10th Cir. 1997). "[C]autionary statements contained in the registration statement may fairly be considered as limiting the forward-looking predictions made in subsequent discussions of the same transaction." *Id.* at 1123. Therefore, the cautionary language in Enron's 10-Ks and Qs applies to the forward-looking statements in Enron's press releases and analyst reports to the extent Enron adopted those reports.

i. Enron Disclosed that EES Contracts Required It to Expend Money and Incur Substantial Costs.

Plaintiffs have alleged that Enron misrepresented the value of the contracts that EES signed with retail customers because EES failed to report or to account for the substantial expenditure of its own monies in connection with its contractual responsibilities. *See* NCC at ¶¶ 37-38, 214(g), 300(g), 339(g). Plaintiffs allege that Enron made false and misleading statements regarding EES contracts because its public statements announcing these contracts omitted to say that EES was required to "pay and invest" substantial amounts of its own money, including payment of rebates and infrastructure investment costs. *See* NCC at ¶¶ 541, 542.

In fact, Enron routinely, and indeed persistently, announced and otherwise acknowledged that the contracts that EES signed with its customers contained significant (and sometimes huge) obligations for Enron itself. With regard to its contract with Owens Corning in September 1999, Enron announced not only that a ten-year $1 billion agreement had been struck, but that the contract required Enron to "*design, build and finance certain energy infrastructure projects*," and that the contract was reached, in part, because of "Enron's ability to ... *furnish capital* ...." Press Release, dated Sept. 22, 1999; NCC at ¶ 171.

In a press release regarding a contract between EES and the San Francisco Giants, Enron announced a 10-year energy commodity agreement and 15-year management contract for Pacific Bell Park and disclosed that EES "would provide the Giants with *capital* to purchase equipment needed to operate the stadium . . ." and that the contract "captured [EES's] core competency – the integration of commodity, *capital* and energy and facility management services. . . ." Enron also disclosed in this release that EES "joins several other distinguished U.S. corporations . . . partnering with the Giants to build the stadium." In connection with EES's contract to provide energy services to Lockheed Martin, Enron stated that it would provide electricity valued at $75 million over four years and disclosed that it also would "*finance*, construct, operate and *maintain [sic] new energy infrastructure* for the company. . . ." The press release elaborated that Enron had "provided . . . a fully integrated energy package including ***capital***, commodity and services . . ." and that Lockheed Martin would "see immediate savings *without having to pay a dime up front*."

Plaintiffs earmark for special criticism EES's 15-year $1.3 billion contract with Eli Lilly and Company, "proudly announced" on February 26, 2001. *See* NCC at ¶¶ 291, 541. They complain that "Enron improperly failed to disclose . . . that to win the contract, "Enron had to pay and invest $168 million up-front . . . ." NCC at ¶ 541. Plaintiffs blithely ignore the fact that the very same press release by which Enron "proudly announced" its agreement with Eli Lilly disclosed that the contract required Enron to provide Lilly "related energy *infrastructure upgrades" and that Enron would perform operations and maintenance of energy assets*." App. Tab 13, at 1.

Instead of hiding EES's contractual obligations, Enron disclosed repeatedly that it would invest substantial portions of its own capital in order to finance the development and upgrading of its clients' energy systems. Enron spoke plainly and clearly about "capital," its capital. From its press releases, the market understood that the structure of the typical EES contract imposed on Enron major financial obligations over a long term. Plaintiffs' allegations to the contrary fail to consider Enron's actual disclosures, some of which are contained in records of which this Court may take judicial notice and several of which are within the very releases cited by the Plaintiffs in their Complaint.

ii. Enron Disclosed that It Used Mark-To-Market Accounting to Report Income from EES Contracts.

Enron's commercial energy services were conducted through EES. *See* SEC App. Tab 15, at 42. Those operations included entering into contracts with customers to deliver energy commodities. The commodity portions of those contracts were accounted for using mark-to-market accounting (*see id.*) as required by EITF No. 98-10. App. Tab 57 at ¶ 7. Under mark-to-market accounting, the contracts were measured at fair value determined as of the balance sheet date with the gains and losses included in earnings. *Id.* The market prices used to value these transactions reflected management's "best estimate considering various factors." SEC App. Tab 15, at 68. Management's "best estimate" represented "the single most likely amount in a range of possible estimated amounts." App. Tab 55.

In determining the fair value of an energy contract, "frequently, quoted market prices in active markets are not available for these contracts, and companies must use other techniques to estimate fair value." App. Tab 58, at ¶ 1. The FASB Emerging Issues Task Force considered "whether certain specified methodologies may be considered unacceptable methods for estimating the fair value" of an energy contract. App. Tab 57, at ¶ 5. The EITF declined to specify, and thus GAAP does not specify, whether any specific measurement technique for estimating fair value is acceptable or unacceptable, and the EITF and GAAP do not proscribe any specific valuation methodology. *See* App. Tab 58 at ¶ 6.

Present value of estimated future cash flows is a method used to estimate fair value in the absence of current market transactions. "Present value should attempt to capture the elements that taken together would comprise a market price if one existed, that is, fair value." App. Tab 56, at ¶ 25. In determining the present value of estimated future cash flows, management had to

(i) project the cash inflows and outflows to occur over the periods of the contract, and (ii) select a present value discount rate that it estimates reflects both the time value of money and the price, expressed as a rate of return, the market would require for an asset or liability with the relevant inherent uncertainty. *See id.*, at ¶¶ 23, 43.

To project the future cash inflows and outflows over the periods of EES's energy commodity contracts, management had to estimate (i) the physical quantities of the energy commodity that would be used by the customer in each period of the contract, and (ii) the variable per unit energy commodity price that EES would either receive or pay, depending on the contract, in each period of the contract. To project the variable per unit energy commodity price that EES would either receive or pay, depending on the contract, in each period of the contract, management had to project the future market prices for the energy commodity; those prices were subject to significant fluctuation. Management also had to project the effect on the volatility of those prices of any offsetting forward or futures contracts EES had entered into to hedge the effects of changes in the future market prices for the energy commodity. Projecting the future effectiveness of the hedge required management to project the extent to which it could be expected that changes in the fair value of the hedge, caused by changes in the underlying price of the energy commodity, would offset changes in the fair value of the hedged contract, and creditworthiness of the counterparty to the hedge. For each of the facts described above that had to be projected, there was a range of possible future outcomes. Management was required to make its own assumptions about the single most likely amount. However, the fact that management had to use its own assumptions did not mean that the result did not reflect fair value. On the contrary, "the use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions." App. Tab 56, at ¶ 38. Of equal significance, Enron told investors that these were matters that involved "estimates" of "probabilities." *See* SEC App. Tab 15, at 67-68

Enron repeatedly announced that mark-to-market accounting principles were appropriate, and indeed required, to account properly for certain future income derived from long-term EES energy contracts. In its SEC disclosure forms, Enron directly and repeatedly explained that trading activities "are accounted for using the mark-to-market method." *See* SEC App. Tabs 1, at 70-71; 2, at 76; 6, at 85; 10 at 73; 15, at 68. Enron further specifically reported beginning in 2000, that "the commodity portion of the contracts associated with this business are accounted for using the mark-to-market method of accounting." SEC App. 15, at 68. That disclosure also referred the reader to Note 1 to the consolidated financial statements, in which, under "Accounting for Price Risk Management," Enron described the predictive aspects of mark-to-market accounting for energy contracts by stating that "[t]he market prices used to value these transactions reflect management's best estimate considering various factors including closing exchange and over-the-counter quotations, time-value and volatility factors underlying the commitments." *Id.*

The investing public was acutely aware not simply that Enron used mark-to-market accounting to value its long-term energy contracts but that such accounting methodologies had significant income statement consequences, *i.e.*, that income could be "front-end-loaded" and that Enron had "flexibility" to structure its contracts to recognize income long before actual cash was realized. These axiomatic elements of mark-to-market accounting were no secret and were reported openly. Thus, as early as a June 9, 1999, a JP Morgan Analyst Report notes quite directly and unremarkably:

> [Enron] has significant flexibility in structuring contracts and hence booking earnings. It is primarily a financial business and hence uses 'mark to market' accounting. As such, contracts can be structured to recognize the economic value of projects long before they are operational and cash is coming in the door. . . . [Mark to market accounting] has two effects: front-end-loaded earnings that bias the denominator in the P/E ratio and a timing disconnect between projects' cash and earnings effects.
>
> App. Tab 21, at 4. *See also*, NCC at ¶ 153.

Consistent with and confirmatory of the nature of mark-to-market accounting as applied to long-term energy contracts, Enron was at pains to emphasize the degree to which its signed contracts created revenue streams realizable only in the future. The variability and volatility of these contracts and the income stream they were assumed to produce is apparent even from Enron pronouncements quoted in Plaintiffs' Complaint.[236]

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[236]*See* NCC at ¶ 120 (10/14/98 analyst report, EES's retail contracts had "an average contract life of *5 years*"); NCC at ¶¶ 128, 130, 131 (01/19/99 Enron report and 01/20/99 analyst reports, EES' signed contracts for "customers' *future* energy expenditures"); NCC at ¶ 132 (01/25/99 analyst report, "*Future retail contracts* are growing; *future undiscounted revenues* should exceed $3 billion by year-end"); NCC at ¶ 138 (Enron 1998 Annual Report, EES signed contracts "representing $3.8 billion of customers' *future energy expenditures*"); NCC at ¶ 172 (09/23/99 analyst report, EES "*10-year*, $1.3 billion total energy services outsourcing contract" with Owens Corning); NCC at ¶¶ 182, 183, 186 (10/12/99, 10/13/99 and 10/20/99 analyst reports, $2.5 billion of *future* customer expenditures for energy services and Owens Corning contract to span a *ten year* period); NCC at ¶ 185 (10/15/99 analyst report concerning contract with Simon Brand Ventures to be performed "over a *ten year* period"); NCC at ¶ 246 (07/24/00 Enron Press Release, "$3.8 billion of customers' *future* energy expenditures"); NCC at ¶ 252 (07/24/00 analyst report, "$3.8 billion of customers' *future* energy expenditures"); NCC at ¶ 269 (10/19/00 analyst report, "$1 billion, *10-year* agreement with Starwood Hotels and Resorts"); NCC at ¶ 281 (01/22/01 Enron Report, "$16.1 billion of new contracts during 2000, representing customers' *future* expenditures" and list of "[m]ajor *long-term* energy management agreements"); NCC at ¶ 291 (02/26/01 Enron press release, "$1.3 billion, *15-year* energy management agreement" with Eli Lilly); NCC at ¶ 315 (04/03/01 Enron press release, "*long-term* energy management agreement with J.C. Penney").

Other portions of analyst reports and Enron press releases – which the Complaint neglects to cite – further highlight the prospective nature of the EES energy contracts.[237]

Finally, Enron repeatedly highlighted the volatility of the energy and financial marks in their 10-Ks and 10-Qs. One of the risks listed in Enron's 10-Ks dated 03/30/00 and 04/02/01, and 10-Qs dated 05/15/00, 08/14/00, 11/14/00, 05/15/01 and 11/19/01 was "the timing and extent of changes in commodity prices for crude oil, natural gas, electricity, foreign currency and interest rates." The public was repeatedly made aware that Enron's ability to service its EES contracts was very much a function of this level of volatility.

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[237]*See* App. Tab 16, at 6-7 (EES "continued to significantly expand contracting activities, signing [*sic*] contract representing approximately $850 million of *future* revenues for delivery of energy."); 17, at 3 (EES "signed contracts representing $3.8 billion of customers' *future* energy expenditures."); 18, at 4 (EES "signed contracts representing $1.8 billion of total *future* energy expenditures…", and "*[f]uture* retail contracts growing; *future* undiscounted revenues should reach $8 billion by year end."); 20, at 3 analyst report, EES "signed contracts representing $1.8 billion of total *future* energy expenditures…"); 19, at 33 (EES "signed contracts that will probably generate more than $3 billion in revenues during the next *10 years*" and EES's "commodity side is simple, low-margin… business with contracts that average *five years* in duration… The outsourcing side has margins of more than 5%, and contracts, which average *10 years*…" and "$1.1 billion contract that EES signed with CSC for the provision of IT services… IT is not EES's core strength, and this *11-year* contract matches the duration of the contracts that EES is entering into with its clients."); 23, at 5 (EES "signed contracts representing $1.8 billion of total *future* energy expenditures…"); 24, at 6 (EES's "Retail contracts are growing and *future* undiscounted revenue should approximate $12 billion by year-end."); 25, at 8 and 26, at 8 (EES Table "Total Energy Expenditures (TEE) – Measure of Undiscounted *Future* Est. Revenues"); 28, at 3 ("Enron Energy Services…announced today a $610 million agreement to provide electricity to IBM over the next *ten years*."); 29, at 2 (Enron Retail Services "New contracts worth $3.8 billion were recorded, including a $1 billion, *ten-year* agreement with Quebecor…)," 30, at 9 (EES "signing contracts representing approximately $1 billion of *future* revenues for delivery of energy and services" and EES's "Revenue more than doubled…as evidenced by the addition during the quarter of contracts representing $3.8 billion of *future* energy expenditures."); 31, at 5 ("ENE's retail energy division generated…a $1 billion, *10-year* agreement with Starwood Hotels and Resorts to provide energy management solutions for its properties."); 32, at 3 ("[a]ssuming an average contract life of *seven years* generates a revenue projection of $8.5 billion for EES in 2002.")

Given this record of extensive public disclosures, it is indisputable that Enron announced, and the investing public knew, that EES's long-term energy contracts were accounted for by mark-to-market methodologies; that mark-to-market accounting required suppositions and estimates about uncertain future events; that income under these methodologies was booked in the quarter the contract was executed, before cash was received; and that Enron (as well as any other entity using the method) had flexibility to structure its contracts to achieve a variety of different income scenarios.

iii. Enron did not Abuse Mark-To-Market Accounting in Connection with Its EES Contracts.

Perhaps recognizing that Enron's disclosure of its mark-to-market accounting treatment of EES contracts was substantial, Plaintiffs retreat to a second claim: in application of the mark-to-market methodology, EES violated GAAP. The primary error that is alleged, at least with sufficient particularity to be understandable, is the assertion that mark-to-market accounting was improper because EES had no "historical track record" with such long-term energy contracts; mark-to-market accounting was purportedly permissible only where contract revenue streams were based on "a historical record of similar transactions" and thus were "predictable." NCC at ¶¶ 36, 535. Plaintiffs provide substantiation for their claim by citing Emerging Issues Task Force (EITF) Abstract 98-10. *See* NCC at ¶¶ 305, 534.

Plaintiffs' allegations are contradicted by their own citation to controlling accounting doctrine. Neither EITF No. 98-10 (nor any other relevant literature) creates a rule that mark-to-market accounting may be applied only where "a historical record of similar transactions" exists. In fact, the tenor and content of EITF No. 98-10 is decidedly to the contrary. EITF No. 98-10 merely requires that energy trading contracts be accounted for using mark-to-market accounting.[238] EITF No. 98-10 is silent as to how market value should be determined for the application of mark-to-market accounting.[239] Plaintiffs also choose to ignore that after the issuance of Abstract 98-10, the EITF issued Abstract 00-17, in which "[t]he Task Force declined to specify whether any specific measurement techniques for estimating fair market value of individual contracts should be considered unacceptable or to proscribe any specific valuation methodologies." Simply put, neither EITF No. 98-10 nor EITF No. 00-17 requires a "historical record" as a prerequisite to the use of the mark-to-market method.

Indeed, Enron had great leeway in determining the proper course for recognizing revenue under GAAP. GAAP "is a term of art encompassing a wide range of acceptable procedures such that an ethical, reasonably diligent accountant may choose to apply any variety of acceptable accounting procedures when that accountant prepares a financial statement." *Lovelace,* 78 F.3d at 1021 (internal quotations omitted). *Accord Lemmer*, 2001 WL 1112577 at *10 ("GAAP requirements upon which [plaintiff] relies appear often to require the substantial application of judgment to the totality of the circumstances."). The existence of a range of acceptable accounting procedures under GAAP is especially relevant here because the business of trading energy contracts was relatively new during the Class Period and there was little guidance found within the formal accounting literature that comprises GAAP. Particularly with respect to energy contracts, the exercise and application of considerable judgment was required in the selection of the methods, models and assumptions to be used in determining fair value of the contracts. The

[238] "The Task Force reached a consensus that energy trading contracts should be marked to market . . . ." App. Tab 57 at ¶ 7.

[239] "Issue 98-10 does not provide explicit guidance on estimating fair value, and in current practice various methods are used." App. Tab 58 at ¶ 1.

EITF understood this and explained that "two companies in similar circumstances might apply different methods to estimate the fair value of their energy-related contracts and may arrive at widely different values." EITF No. 00-17 at ¶ 1. *See also* EITF No. 00-17 at ¶ 7 ("Recognizing that determining fair value often is subjective, some are concerned that alternative approaches to measuring fair value may provide significantly different answers.").

Because GAAP itself recognizes that wide variations in mark-to-market accounting are to be expected, Plaintiffs must do more than cry "abuse" to state a claim. They cannot rest on 214(f)m 300(f), 339(f).[240] They must explain, in transaction-specific terms, why the mark-to-market methodology used by Enron was outside the range of permissible variation, what the correct methodology was, what income should have been reported had the correct methodology been used and whether that difference was material. See also *In re Waste Management,* Slip Op. at 140-41. They must allege facts sufficient to show that particular defendant consciously selected an incorrect methodology. They must allege when this happened and who knew about it. The reader searches the Complaints in vain for these critical details. In their conclusory style, Plaintiffs have replicated the error of the *Waste Management* plaintiffs, whose failure to particularize or identify balance sheet effect was a ground for dismissal. *See Waste Management,* slip op. at 140-41. What the Plaintiffs may disagree with Enron's decision to apply mark-to-market accounting to its long-term energy contracts. But they have pled nothing to suggest that this was improper, much less fraudulent.

[240] *See BMC,* 183 F. Supp. 2d at 865 n.13 ("[C]onclusory allegations or legal conclusions masquerading as factual conclusions do not defeat a motion to dismiss.") (*citing Shuhany v. Allwaste, Inc.,* 992 F.2d 517, 520, 523 (5th Cir. 1993).

Even granting Plaintiffs that mark-to-market accounting should not have been used by EES (which we dispute), the question was open to debate, close and quite uncertain – as all the literature (including that cited by Plaintiffs) demonstrates. In these circumstances, deviations from GAAP provide no basis upon which to draw inferences of scienter. As the Fifth Circuit has stated, "[t]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter. To violate the anti-fraud provisions of the securities law, the party must know that it is publishing materially false information, or must be severely reckless in publishing such information." *Lovelace,* 78 F.3d at 1020 (citing to *Fine v. American Solar King Corp.,* 919 F.2d 290, 297 (5th Cir. 1990*), cert. dismissed sub. nom., Hurdman v. Fine,* 502 U.S. 976 (1991). S*ee also In re Paracelsus Corp. Secs. Litig.,* 61 F. Supp. 2d 591, 599 (S.D. Tex. 1998). Plaintiffs must provide specific facts that the Enron Defendants knew that accounting methods were fraudulent or acted with severe recklessness. *See Lovelace,* 78 F.3d at 1018, n.2. Alleging accounting errors and irregularities, or even that a company has restated its earnings, does not establish a strong inference of scienter. *See Paracelsus,* 61 F.Supp.2d at 599; *In re ComShare Inc. Securities Litig.,* 183 F.3d 542, 554 (6th Cir. 1999); *San Leandro Emergency Med. Plan v. Philip Morris Cos.,* 75 F.3d 801, 812-13 (2d Cir. 1996).

b. PLAINTIFFS FAIL TO PLEAD FRAUD WITH PARTICULARITY AND FAIL TO RAISE A STRONG INFERENCE OF SCIENTER IN CONNECTION WITH ANY EES BUSINESS ACTIVITY.

Considering the force and volume of Enron's disclosures, Plaintiffs must plead the inadequacy of those disclosures with great particularity. *See Lovelace*, 78 F.3d at 1019-20 ("At most, Plaintiffs' first allegation indicates that Defendants' disclosure was incomplete; however, such an allegation falls far short of identifying conscious behavior on the part of the

Defendants."). Even in the absence of those disclosures, however, Plaintiffs face the strong pleading requirements of Rule 9(b) and the PSLRA as regards the particularity of their allegations of securities fraud. Measured against these requirements, Plaintiffs fail.

i. Allegations About Mark-to-Market Accounting are Deficient.

Plaintiffs repeatedly allege that EES abused mark-to-market accounting. They assert generally that too much revenue was recognized at too early a stage. *See generally* NCC at ¶¶ 214(f), 300(f), 339(f). These allegations omit any particularized discussion of how mark-to-market accounting was wrongly applied, what the correct methodology was, and what income should have been reported had the particular contract been accounted for properly. In general, Plaintiffs have failed both to identify the asset that was purportedly misaccounted for and to identify the material change in the income statement that would have followed. In their conclusory style, Plaintiffs have replicated the error of the *Waste Management* plaintiffs, whose failure to particularize or identify balance sheet effect was a ground for dismissal. *See Waste Management*, slip op. at 140-41. In fact, Plaintiffs' allegations are so vague and non-specific they deprive Defendants of fair notice of their individual alleged wrong doing Fed. R. Civ. P.8.

ii. ALLEGATIONS ABOUT THE LILLY CONTRACT FAIL TO COMPLY WITH THE PSLRA.

Plaintiffs focus most closely on a contract that EES signed with Eli Lilly in 2001. *See* NCC at ¶¶ 300(g)(iv), 540-43. Plaintiffs claim that the contract had hidden costs and was improperly overbooked at an early stage. They further assert that anonymous persons "knew" that the contract would "lose" money. Even as to the Lilly contract, Plaintiffs come up short in numerous key respects.

First, as we have noted, Enron made no secret that its agreements with its customers often required that it bear certain infrastructure upgrade costs and finance or advance money for other capital expenditures. Enron disclosed these obligations in connection with a variety of contracts, and they were widely known. Having routinely disclosed – even touted – EES's ability to achieve cost-savings by replacing customers' old equipment with more energy-efficient technology, Enron's press release on the Lilly deal specifically noted that EES would, among its other duties, "perform . . . energy infrastructure upgrades (to Lilly's energy assets) that will increase energy efficiency at Lilly facilities." App. Tab 13, at 1. The obligation to Lilly was in no way hidden from the public, because Enron made it public.

Plaintiffs assert that in the case of the Lilly contract, these Enron obligations – including a rebate which Enron paid Lilly advancing some of its predicted savings – caused the Lilly contract to "lose" money. Just why the contract would "lose" money, over what period the losses would be incurred (the first year or ten years), who "knew" it, how and when – all of these particularizing details remain curiously missing. This Court has seen the same level of generality in pleading in other contexts in connection with the development of landfills (*see Waste Management*). Such vagueness is no more sufficient here than it was there.

This Court's analysis of plaintiffs' inadequate treatment of the landfill assets in *Waste Management* and their pleading deficiencies is instructive. In that case, the plaintiffs made the following allegation:

> Defendants filed several false Form 10Qs which overstated by tens of millions of dollars the property and equipment of the company, because the company recorded on its balance sheet the price it <u>paid</u> for landfills as their value, even though that price was based on excessively estimated use of the landfills at the time of their acquisition. *Waste Management,* Slip op. at 30.

This Court dismissed the *Waste Management* plaintiff's complaint in part because "Plaintiff fail[ed] to demonstrate with any particularity for even one landfill the amount by which the valuation was overstated and why or to provide details about the method employed to project its estimated usage." *Waste Management*, Slip op. at 185. The Court also noted the plaintiff's failure to allege a change in circumstances that would have indicated to defendants that the carrying amount of the landfills might not be recoverable. *Id.* at 142.

Plaintiffs fail here as well. The essence of their claim – that the Lilly contract was improperly marked to market at numbers unjustifiably high during the first quarter of 2001 – is a mishmash as pled in NCC at ¶ 300(g)(iv). The essence of the paragraph seems to plead a disclosure claim – that upfront Enron costs were concealed – but that claim is refuted by various disclosures that we have discussed. Interspersed in the paragraph is the vague assertion that the actual value of the contract was somehow less (Plaintiffs pluck the number "$267 million" without explanation) and that the income figure recognized in the Enron financial statement for the first quarter of 2001 for this transaction was "without any basis in fact."

Insofar as Plaintiffs' allegations in paragraph 300(g)(iv) are intended to describe with particularity a deficiency in the manner by which the Lilly contract was marked to market, they are a complete muddle. Although Plaintiffs plead a comment from the press release that Lilly would pay $1.3 billion over the life of the contract for various commodities and services provided by Enron, Plaintiffs do not plead the value of the payment stream from Lilly that Enron used for mark-to-market purposes. Put another way, the reader of paragraph 300(g)(v) has no way of knowing how Enron valued the revenues generated by the contract for accounting purposes -- or whether that was inaccurate or misleading. Similarly, the reader has no way of knowing how Enron calculated its costs -- or whether they were some how in error. Reduced to its essentials, all Plaintiffs say is that Enron had upfront costs which it failed to disclose (which is inaccurate) and that it wrongly accounted for income in the first quarter of 2001, without explanation as to why or how.

The numeric veneer that Plaintiffs offer notwithstanding, the Lilly allegations are indecipherably general. Plaintiffs actually assert only the Lilly contract was not properly marked to market because "assumptions" that were "not supportable" were used. What erroneous "assumptions" were used and how they were used, Plaintiffs do not favor the reader with. Plaintiffs attempt to substitute conclusory characterizations, adjectival constructions ("unrealistic projections," "illusory profits"), seasoned with a dash of adverbial emphasis ("inappropriately using mark-to-market accounting," "improperly book"). NCC at ¶ 543. But adjectives and adverbs do not take the place of facts – nouns that describe the time, place, and circumstance of the fraud that is alleged. *Cf. BMC*, 183 F.Supp. 2d at 865 n.13, (rejecting conclusory allegations masquerading as fact). That detail is missing here, even taking the very best view of Plaintiffs' Lilly allegations that one can. Not only is this not "fair notice," it is no notice at all.

iii. Allegations Based on Employee Speculation Should Be Disregarded.

Plaintiffs' reference to the beliefs of a former employee (one Glenn Dickson), NCC at ¶ 542, regarding the Lilly contract and other events adds nothing. First, the Complaint does not plead that Mr. Dickson had any familiarity at all with the actual Lilly contract, that he worked at Enron during the period that the contract was negotiated, or that he understood its particulars. In addition, the Dickson statements are little more than a claim that anonymous employees "knew" that unnamed contracts were losing money and were misaccounted for. This is precisely the kind of vague claim disapproved in *Waste Management.* It is also and one that is impossible to respond to in any meaningful way. Plaintiffs may not circumvent their obligations under Rule 9(b) and the PSLRA by substituting the speculation of a third-party for their own. *Cf. Lujan v. National Wildlife Federation*, 497 U.S. 871, 888 (1990) ("the object of [F.R.C.P. 56] is not to replace conclusory allegations of the complaint or answer with conclusory allegations of an affidavit."); *Castillo v. Bowles*, 687 F. Supp. 277, 280 (N.D. Tex. 1988) ("General conclusory allegations . . . do not become sufficient simply because they are put in affidavit form and stated by someone other than the plaintiff.") Even affidavit testimony based on information and belief is routinely disregarded by the courts. *See Isquith v. Middle South Utils. Inc.*847 F.2d 186, 194-95 (5th Cir. 1988).

For much the same reason, the *Newby* Complaint's multiple references to an August, 2001, memorandum by an unnamed EES manager to the Enron Board claiming that Enron was trying to hide the losses experienced by EES in the wholesale division adds no additional weight to the Plaintiffs' allegations of securities fraud. In the first place, the author of the memorandum is reporting her or his speculation and/or rumors among employees. The memorandum even begins with the phrase "one can only surmise. . . ." *See* NCC at ¶¶ 59, 358. In describing the losses that EES is allegedly trying to hide in wholesale, the memorandum says that "[r]umor on the 7th floor is that it is closer to $1 Billion. . . ." *See* NCC at ¶¶ 59, 358. Again, Plaintiffs may not circumvent the requirement that fraud be pled with particularity by substituting the speculation of a third party for their own. Given that allegations based on information and belief may be disregarded under the PSLRA, 15 U.S.C. § 78u-4(b)(1), allegations of an apparent witness based on their information and belief cannot constitute a well-pled fact. *See BMC*, 183 F.

Supp. 2d at 885-86, n.15 (". . . [I]f an allegation regarding the statement or omission is made on information and belief, they must state with particularity all the facts on which that belief is based.").

Furthermore, the August 2001 memorandum provides no facts from which an inference can be drawn that the consolidation of retail and wholesale trading operations was the result of intent to defraud investors, yet another vignette offered by Plaintiffs. To the contrary, the only inference to be drawn from the facts, which were fully disclosed in Enron's securities filings several months before this individual's memoranda, is that the transfer was a normal business decision. EES announced to the investing public changes in the structure of its internal organization and redefinition of its segments (in compliance with the Statement of Financial Accounting Standards No. 131), in the financial statements which accompanied its Form 10-Q filed on May 15, 2001. Note 6 to those financial statements explained that "the commodity-related risk management activities of the Retail Energy's North American customer contracts were transferred to the Wholesale Services segment, consolidating all energy commodity risk management activities into one operating segment." SEC App. Tab 17, at 12. Enron also highlighted this change in its first quarter earnings release for 2001 which proclaimed that "[b]eginning in 2001, risk management activities associated with Enron's retail customer contracts are managed by Wholesale Service, consolidating all energy commodity risk management activities within one business unit." App. Tab 12, at 3. The release also included a table showing the financial effect of the segment change and comparing what Retail's financial results for 2000 would have been under the new policy versus the old. While the memorandum's author may have disagreed with the reorganization, its timely disclosure negates the inference that this business decision was another badge of Enron's supposed fraud.

iv. Other "Garnish" is Insubstantial.

Plaintiffs sprinkle several other observations about EES throughout the *Newby* Complaint, none of which add to the matrix of particularity required by Rule 9(b) and the PSLRA. They apparently complain about a transaction involving an entity entitled "JV-Company" which performed certain services under the Owens-Illinois contract such that certain EES expenditures were moved "off its books." *See* NCC at ¶ 496(b). Plaintiffs give no further explanation for the transaction nor why it was improper. Indeed, the reader is left to guess whether Plaintiffs claim the transaction to have been improper since Plaintiffs avoid even a conclusory claim of impropriety in the two-sentence description of the transaction.

Plaintiffs assert that Enron on occasion misbooked revenue from the "long-term services" portion of EES contracts under a mark-to-market method. *See* NCC at ¶ 535. No particulars are offered; no amounts are given; no contracts are identified. Plaintiffs assert that contracts were valued on unreasonable assumptions and that Enron frequently chose aggressive valuation models. *See* NCC at ¶¶ 33, 536, 537. No detail is provided, no contracts identified, and no amounts are given. It is even unclear that these allegations are meant to refer to EES.

Plaintiffs complain that Enron "did not have sufficient infrastructure to do the monthly billing" for EES customers. NCC at ¶ 300(g)(i). They offer no other detail to the claim. Other than describing this purported condition as "insurmountable" (NCC at ¶ 300(g)(i)), Plaintiffs do not describe its consequences, its financial statement impact, or any other circumstance suggesting inferences of fraud. Comparably general claims of resource inadequacy have been rejected as evidence of fraud. *See, In re Party City Securities Litigation*, 147 F. Supp. 2d 282, 301 (D.N.J. 2001) (allegations that company's internal financial and accounting systems could not service rapidly expanding business are insufficient under Rule 9(b) and PSLRA because they failed to specify, *inter alia*, any effect on financial results; *K.B.R. Inc. v. L.A. Smoothie Corp.*, 1996 U.S. Dist. Lexis 4552 *26 (E.D. La. April 3, 1996), *aff'd* 136 F.3d 1328 (5^{th} Cir. 1998) (Defendant's "recordkeeping was not everything it should be, but . . . that would fall into the category of mismanagement or negligence not fraud . . . .").

Plaintiffs complain about a contract that EES signed with Quaker Oats in which a revenue allocation was purportedly made between "services" and "commodities" for the purpose of computing mark-to-market income. *See* NCC at ¶ 557. The essence of this complaint is apparently that Enron used "the open market value" of the energy commodities as the basis for determining commodity value (which had to be marked to market) as opposed to a figure derived from what "Quaker had historically paid for energy commodities." *See* NCC at ¶ 557. This, Plaintiffs allege, allowed Enron to show a "hefty profit" on the deal. *Id.* Plaintiffs again do not favor the reader with any particularized description of why this conduct was wrong and what accounting principle it violated, much less why the violation was clear and knowing. The reader is left to speculate. To the extent that one can devine Plaintiffs' allegation here, it appears to be founded on the misreading of EITF No. 98-10 and 00-17 to which we have earlier spoken. "Historical record" is not a prerequisite to mark-to-market accounting treatment nor a necessary basis upon which to determine value. No set valuation models are prescribed by applicable doctrine and the range of reasonable variables and results is very broad. To the extent Plaintiffs mean the Quaker transaction to constitute actionable conduct in some other sense, they are obliged to say a great deal more than they have.

Plaintiffs mix in a few contracts (J.C. Penney, IBM, and CitiGroup) which they conclusorily assert were "known losers" from the outset. *See* NCC at ¶ 544. Plaintiffs continue their convenient pleading style of writing in the passive voice; no individuals are identified as persons who "knew" this to be the case. No detail is given as to when or why this was the case. The essence of the observation is essentially a broad, conclusory mismanagement claim, disapproved in a variety of cases that has been discussed earlier.

Reduced to its essentials, Plaintiffs plead at best a claim that EES was mismanaged, that it was unwisely optimistic in evaluating its prospects and overconfident in its ability to reduce costs when it agreed to underwrite substantial capital improvements for customers. And that is all they plead. But "'[c]orporate mismanagement does not, standing alone, give rise to a 10b-5 claim, and *meas culpa* does not sufficiently satisfy the scienter requirements of pleading in securities fraud cases. . . .'" *BMC*, 183 F. Supp. 2d at 889-90 (citing *Tuchman*, 14 F.3d at 1070). Plaintiffs' claims regarding EES should be dismissed.

D. THE NEWBY PLAINTIFFS FAIL TO STATE A CLAIM FOR ALLEGED FRAUD AGAINST ANY DEFENDANT UNDER THE PSLRA RELATING TO ENRON'S PROJECTS IN DEVELOPING NATIONS AND FOR AZURIX.

Plaintiffs fail to state a claim for alleged fraud against any Defendant under Rule 8, Rule 9(b) or the PSLRA relating to Enron's projects in developing nations and for Azurix.

The *Newby* Plaintiffs[241] argue in the Complaint that Enron's investment in Azurix Corp. "stumbled," and that a portion of its projects in India, China, the Dominican Republic, and other emerging nations turned out to be "financial disasters."[242] In connection with Enron's contract to develop a clean-energy power company in Dabhol, India, for instance, Plaintiffs state:

> In 95, after $300 million in work had been completed, the [Dabhol] project was halted due to political changes in India. Enron had to agree to lower the rates it would charge for power once it was online to get it started again.[243]
>
> * * *
>
> By late 01, Enron and its partners had invested more than $1 billion in building Dabhol, but these costs were not recoverable. The problem was that the rates envisioned for consumers in India were several times higher than other rates in the country. Additionally, Enron continued to have regulatory/political problems in finalizing the project.[244]

Similarly, in connection with Azurix, Plaintiffs argue:

> Wessex Water had been expected to be the main revenue source for Azurix but results were disappointing after regulators forced the company to cut prices by 12%, leaving Azurix without its main source of cash.[245]

Plaintiffs make no effort, however, to describe any facts that would state a claim for securities fraud. The Complaint does not even attempt to plead fraud by hindsight: Plaintiffs do not allege that any individual Defendant had *fore*knowledge of political problems or other events

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[241]The *Tittle* Plaintiffs make very limited allegations concerning Enron international business, most of which are focused on Enron's investment in Azurix. *See* TCC at ¶¶ 388-395.

[242]NCC at ¶ 155(h), (i) & (n); ¶ 214(m), 590; *see also* TCC at ¶ 668 ("The [Dabhol] project is a total disaster for the Company").

[243]NCC at ¶ 598.

[244]NCC at ¶ 599.

[245]NCC at ¶ 590.

that they claim to have affected Azurix, Dabhol, and other projects in foreign countries. They fail to plead any facts to show when or how any individual Defendant supposedly became aware of any previously undisclosed or misstated information regarding those projects. The Complaint utterly fails to comply with the stringent pleading requirements of Rule 9(b) and the PSLRA.

Importantly Plaintiffs do not allege that Enron ever failed to timely disclose developments on its foreign projects *as they occurred*. And for good reason. The quotations detailed below show that Enron consistently and accurately disclosed to the public the very "financial disasters" that Plaintiff now recite in their Complaint. Even <u>before</u> the beginning of the alleged class period, Enron: i) publicly disclosed the delays that Enron had experienced in the completion of construction projects in some of its foreign markets, including the 1½-year shutdown of construction on Dabhol that is alluded to in the Complaint and the subsequent government termination, ii) described the enormous challenges faced by Enron's projects due to "political instability" in these foreign markets, iii) disclosed its deferral of expenses for some projects, in accordance with allowable practice under GAAP, and iv) cautioned that the absence of "infrastructure" and the instability inherent to emerging nations posed a risk that commercial operations of constructed projects <u>*might never commence at all*</u>. The success of these disclosures is shown on the face of the Complaint: Plaintiffs quote several analysts' reports, all of which show that the public was aware of the highly publicized events in India, Argentina, China, and other foreign nations that affected Enron's international business.

The Complaint also fails because Enron identified specific risks and uncertainties that applied to its foreign projects, as detailed below, and drew specific attention to forward-looking statements contained in its public filings. Those public statements invoke the safe-harbor and bespeaks-caution doctrines of the PSLRA.

In short, as a matter of law Plaintiffs fail to state a claim for securities fraud in connection with Enron's operations in emerging nations. Their allegations should be dismissed.

1. THE NEWBY PLAINTIFFS' ALLEGATIONS REGARDING ENRON'S DABHOL POWER COMPANY PROJECT IN INDIA MUST BE DISMISSED.

A. PLAINTIFFS' VAGUE AND CONCLUSORY ALLEGATIONS REGARDING THE DABHOL PROJECT FAIL EVEN MINIMALLY TO COMPLY WITH THE PSLRA.

Plaintiffs argue that the Dabhol Power Plant project in India turned out to be a "financial disaster." Plaintiffs do not plead a single instance, however, in which any individual Defendant was supposedly aware of undisclosed or misstated information. Instead, Plaintiffs make the conclusory argument that "*Enron* knew" from discussions with unnamed officials that India "would" oppose its energy rates despite the provisions of Enron's written contract. Plaintiffs claim:

> Enron's Dabhol power plant in India was a financial disaster, the completion of which had resulted in huge cost overruns such that to ever recover its investment, Enron would be required to charge electricity rates so much in excess of existing rates in that region that Enron's rates could never be collected. Consequently, the purported valuation of Dabhol on Enron's balance sheet was grossly inflated, which, in turn, inflated Enron's assets and distorted its apparent creditworthiness. In addition, Enron knew from discussions with government officials in India that they would oppose paying Enron for power from Dabhol at anywhere near the rates Enron intended to charge and, in fact, was charging after the plant began commercial operations. Dabhol would not be a strong contributor to earnings and profit.[246]

[246]NCC at ¶ 155(h); see also TCC at ¶386 (referring to unspecified "valuation issues" regarding Enron's international assets.)

Plaintiffs do not mention on what date(s) — or even what *year* — those discussions supposedly took place. They do not reference what, if any, specific balance sheet was supposedly affected by those discussions -- how the value of Dabhol was calculated or why it was allegedly "inflated." They do not indicate who supposedly had those discussions with the unidentified Indian "officials." They do not purport to quote any of those alleged discussions, and instead offer only speculation about what "Enron" would have known would transpire *in the future*, based on the alleged participation by unnamed Enron personnel in those unspecified discussions. Finally, and critically, Plaintiffs do not specify to any information regarding the problems in India that allegedly was not disclosed.[247]

The PSLRA requires dismissal of allegations that fail to provide not only details of the alleged transactions, but details of each Defendant's alleged involvement in and knowledge of undisclosed facts. On the face of the Complaint, Plaintiffs provide no such information as to Dabhol. *Tuchman,* 14 F.3d at 1070.

In the instant case, the *Newby* Plaintiffs fail to identify when the alleged "discussions" supposedly occurred, who participated in them, or the specific information imparted. They fail even to paraphrase what specific statements were made, or by or to whom they were made. The alleged "discussions" are particularly a mystery, since their alleged existence would flatly

[247]Plaintiffs write, "Consequently, the purported valuation of Dabhol on Enron's balance sheet was grossly inflated, which, in turn, inflated Enron's assets and distorted its apparent creditworthiness." What balance sheet? For what year? What was the alleged amount of overstatement? When did any individual Defendant become aware of facts that made him or her aware that a valuation was rendered incorrect, due to the subsequent delays and overruns that occurred? What disclosures were made, and in what way were they incorrect or otherwise insufficient? *Plaintiffs supply none of these facts*, let alone with the particularity demanded by the PSLRA's "who-what-when-where and how" that plaintiffs know are required pleading elements.

contradict the written contract that Enron signed with the Indian government: it not only stated that Enron *would* be paid these those rates for power transmission -- the government *guaranteed* payment.

The *Newby* Plaintiffs provide no facts as to when (if ever) any individual Defendant became aware of any alleged undisclosed information that would adversely affect the Dabhol project. Instead, Plaintiffs simply allege:

> By *late 01*, Enron *and its partners* had invested more than $1 billion in building Dabhol, but these costs were not recoverable. The problem was that the rates *envisioned* for consumers in India were several times higher than other rates in the country. Additionally, Enron continued to have *regulatory/political problems* in *finalizing* the project.

"Late 2001," of course, was when Enron filed bankruptcy. Even at that point in time, Plaintiffs fail to reference any misconduct by any individual. They do not allege that Enron failed to disclose the "regulatory/political problems" as they occurred, or even how much money was invested by Enron (as opposed to its partners). The pleading is devoid of facts to show fraud, even by hindsight. None of the paragraphs of the Complaint that reference Enron's project in India make any pleading of specific facts in compliance with Rule 9(b) or the PSLRA. Those allegations must be dismissed.[248]

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[248]The Complaint repeats the same allegations regarding Dabhol over and again — sometimes duplicating entire paragraphs verbatim. *See* NCC at ¶¶ 14(a), 69, 112, 121(f),137, 142, 155(h) & (i), 169, 178, 189-90, 214(m), 216, 273, 279, 305, 309, 314, 327, 330, 337, 342, 388, 581-82, 598-602, 614, 680,701,779. Several paragraphs acknowledge that there was actual disclosure both by Enron and in other public documents of the political and delay problems on the project, as quoted in greater detail below.

B. Enron Consistently Disclosed the Same Events Affecting the Dabhol Project that are Referenced in the Complaint. The Complaint Reflects no Undisclosed Events Regarding Dabhol.

The *Newby* Plaintiffs next catalogue a series of setbacks that they claim "dogged" the Dabhol project from the beginning of the project. Plaintiffs fail to point out, however, that each of those developments *was publicly disclosed* by Enron *when* they occurred. They were widely reported in investment-market periodicals as well, including periodicals that Plaintiffs cite in their Complaint.

Plaintiffs repeatedly allege, for example, that the Dabhol project suffered from political conflicts that led to construction delays, and consequently, to cost overruns.[249] Plaintiffs plead:

> Originally, the first phase was to begin construction in 94 and begin commercial operation in early 97. The second phase was to begin construction in 95. The project was dogged with problems from the beginning. In 95, after $300 million in work had been completed, the project was halted due to political changes in India. Enron had to agree to lower the rates it would charge for power once it was online to get it started again. However, even by 02, the project was still not finished.[250]

Even before the alleged class period, however, Enron had *already* disclosed those events. In fact, Enron did so in much greater detail than Plaintiffs provide in their Complaint. For instance, in Enron's 1996 Form 10-K, almost two years prior to when the alleged class period commenced, Enron disclosed details regarding the specific political turmoil that led to a 1½-year shutdown to construction.[251] Enron disclosed:

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[249]*See, e.g.*, NCC at ¶ 155(h), 598, 614.

[250]NCC at ¶ 598.

[251]*Lovelace*, 78 F.3d at 1017 (Court may consider SEC filings in ruling on a motion to dismiss).

Enron International Inc. is involved in power and pipeline projects in varying stages of development, financing or construction in India, Turkey, Italy, Puerto Rico, Bolivia, Brazil, Indonesia, Guam, Vietnam, Mozambique and elsewhere. ... Other than as noted below, there can be no assurances that these projects will commence commercial operations.

India. In connection with a Power Purchase Agreement between Dabhol Power Company, Enron's 80%-owned subsidiary, and the Maharashtra State Electricity Board (the "MSEB"), Dabhol Power Company began developing Phase I of an electricity generating power plant south of Bombay, State of Maharashtra, India. In August 1995, after construction had begun, a new coalition government in the State of Maharashtra announced the State government's intention to terminate the project, and construction ceased on August 8, 1995. In response to these actions, Dabhol Power Company initiated arbitration proceedings in London against the State government for the actions it had taken to terminate the project, seeking to recover all of its construction and other expenses in addition to lost profits. After the arbitration proceedings had begun, Dabhol Power Company began renegotiating the Power Purchase Agreement with the MSEB and the Maharashtra State government. Such renegotiations, which have been successfully completed, have resulted in a restructured transaction (that includes both Phase I and Phase II and that increases the planned capacity of the facility) on terms that are acceptable to Enron. All approvals for the restructured transaction have been received and, in December 1996, construction resumed on the project and Dabhol Power Company terminated the arbitration proceedings. ... Phase I is expected to begin commercial operations in late December 1998. ....[252]

Plaintiffs appear to second guess Enron's decision *not* to abandon the $300 million it had invested in construction of Dabhol as of August 1995, but even that fact was disclosed to the public. The above disclosure states that in spite the Indian government's earlier conduct, Enron decided to proceed with construction instead of prosecuting the arbitration action for termination damages, that it "renegotiated" the Dabhol contract, and that "construction resumed."

Plaintiffs further argue that Enron told the public in its December 31, 1997 Registration Statement that "Phase I" of the Dabhol project would begin commercial operations one year later,

[252]SEC App. Tab 1, at 15-16. The information is repeated under the heading "Litigation and Other Contingencies."

in December 1998. They claim that this projection was false and misleading because it turned out that Phase I began operations five months later instead, in May 1999, and that the plant was destined to have huge losses. Plaintiffs ignore, however, that Enron *simultaneously* disclosed that the "expected" commencement of Phase I operations could be pushed into 1999 instead of 1998 as a consequence of delays.[253] At the same time, it disclosed that construction of Phase II would not occur until at least "late 2000" — two years in the future.[254] More importantly, Enron specifically told the public that there "can be *no assurances* that these projects *will commence commercial operations*." In other words, Enron told the public that the Dabhol project *might never operate at all*.[255]

Each of these disclosures concerning the prospects for delay was made prior to the alleged class period -- but they continued *throughout the class period*. In the October 10, 1997 and October 16, 1997 Form S-4/A Registration Statements, again prior to the commencement of the alleged class period. Enron told the public that its initial projected start date for Phase I had been pushed back. Enron wrote:

> Unanticipated delays have been experienced in the development and construction of several of the projects designated by Enron at the time of EPP's formation ..., notably the planned power plant, fuel facilities and related ancillary facilities in Dabhol, India and [China and Turkey]. At the time of EPP's initial public offering, the Dabhol project was anticipated to be offered to EPP in 1997. This was delayed due to a decision by the State of Maharashtra to cancel and then

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[253] SEC App. Tabs 69, at 23; 70, at 24. Phase I did commence commercial operations in 1999. Newby quotes at least one announcement reporting that fact, NCC at ¶ 216, and never mentions any differing actual start date. In any event, Enron's projections about when operations would begin in the future are not actionable as a matter of law.

[254] SEC App. Tab 2, at 19-20.

[255] *See, e.g.*, SEC App. Tab 1, at 15-16; 2, at 19-20.

> renegotiate the projects. It is now anticipated that the Dabhol project will go into commercial operations (and thus be eligible to be offered to EPP) in December 1998 or January 1999.[256]

Enron also disclosed that Phase II of Dabhol was also being delayed beyond the earlier projections.[257] In its 1999 Form 10-K, under its "Developing Markets" section, Enron pointed out that Phase I has been completed in May 1999,[258] but that Phase II was being revised to commence in late 2001 instead of late 2000:

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[256]SEC App. Tab 69, at 23; 70, at 24.

[257]Enron disclosed in its 1997 Form 10-K that it did not even intend to arrange financing until the next year, and that it expected operations to begin in late 2000 — a projection three years into the future. Enron subsequently revised the projected completion of Phase II of Dabhol to "late 2001," and again promptly disclosed that revised projection to the public. Enron stated:

> Enron is currently developing Phase II of the Dabhol power project, a 1,624-megawatt combined-cycle power plant to be fueled by natural gas. A 20-year power purchase agreement has been signed with the MSEB. Financing of Phase II is targeted for 1998, with commercial operations expected to *commence in late 2000*. SEC App. Tab 2 at 20.

[258]The May 1999 startup was later than the January 1999 projection. Enron, however, disclosed the actual commencement in May 1999 for commercial operations for Phase I, once they began. *See* SEC App. Tab 10, at 13.

> In connection with a Power Purchase Agreement between Dabhol Power Company, Enron's 60%-owned subsidiary, and the Maharashtra State Electricity Board (the "MSEB"), Dabhol Power Company has constructed Phase I of an electricity generating power plant south of Mumbai, State of Maharashtra, India. The power plant has an initial capacity of 826 megawatts (gross) (Phase I), which began commercial operations in May 1999. ...
>
> Enron is currently developing Phase II of the Dabhol power project, a 1,624-megawatt (gross) combined-cycle power plant to be fueled by natural gas. A 20-year power purchase agreement has been signed with the MSEB. Financing of Phase II is completed, with commercial operations expected to commence in late 2001. ...

In its 2000 Form 10-K, Enron once again reiterated that what it told the public a year earlier: Phase II was expected to commence in "late 2001." Enron publicly disclosed:

> Enron owns or operates various energy assets and investments in certain developing markets outside of North America and Europe, including the following:
>
> A 50% voting interest in Dabhol Power Company, which developed and owns an electricity generating power plant south of Mumbai, State of Maharashtra, India. Phase I of the power plant has an initial capacity of 826-megawatts and began commercial operations in May 1999. Construction on Phase II, a 1,624-megawatt combined-cycle power plant to be fueled by natural gas, is expected to be completed in late 2001. ... SEC. App. Tab 15, at 12.
>
> In connection with a Power Purchase Agreement between Dabhol Power Company, Enron's 60%-owned subsidiary, and the Maharashtra State Electricity Board (the "MSEB"), Dabhol Power Company has constructed Phase I of an electricity generating power plant south of Mumbai, State of Maharashtra, India. The power plant has an initial capacity of 826 megawatts (gross) (Phase I), which began commercial operations in May 1999. ...
>
> Enron is currently developing *Phase II of the Dabhol power project*, a 1,624-megawatt (gross) combined-cycle power plant to be fueled by natural gas. A 20-year power purchase agreement has been signed with the MSEB. Financing of Phase II is completed, with *commercial operations expected to commence in late 2001.* ... SEC App. Tab 10, at 13.

Enron also tempered each of its predictions of future completion dates with cautionary language. It stated that all aspects of Dabhol and other foreign projects were fraught with uncertainty, and that its forward-looking predictions were subject to the inherent risk of doing business in an emerging nation. Even before the alleged class period, Enron publicly stated:

> In addition, these projects are, to varying degrees, subject to all the risks associated with project development, construction and financing in foreign countries, including without limitation, the receipt of permits and consents, the availability of project financing on acceptable terms, *expropriation of assets, renegotiation of contracts with foreign governments and political instability, as well as changes in laws and policies governing operations of foreign-based*

> *businesses* generally. Other than as noted below, there can be no assurances that these projects *will commence* commercial operations.[259]

Enron warned the public *as early as the 1996 10-K* about the risks of "renegotiation of contracts with foreign governments" and "political instability." Those warnings turned out to be prescient. Despite the fact that the Indian government executed a contract agreeing to the rates that Enron charged for the Dabhol plant, and despite its guarantee of payment, the government reneged. And, again, Enron disclosed those facts to the public promptly--and <u>in the middle of the proposed class period</u>. In the March 2001 Form 10-Q, under the heading of "RECENT DEVELOPMENTS," Enron disclosed:

> India. ... Enron accounts for its investment in Dabhol under the equity method and the debt of Dabhol is non-recourse to Enron. *Dabhol has been in dispute with the Maharashtra State Electricity Board (MSEB), the purchaser of power from Dabhol, and the Government of Maharashtra (GOM) and the federal government of India (GOI), the guarantors* of payments by the MSEB pursuant to the terms and conditions of the power purchase agreements (PPA) and the other project documents. The contract disputes relate principally to the *failure by the MSEB to pay certain capacity and energy payments under the PPA, and the failure of the GOM and GOI to satisfy certain guarantee obligations under the project documents. There is no assurance that Dabhol will be able to resolve such disputes to its favor and to successfully collect on and to enforce any judgment or settlement.* However, Dabhol believes that the MSEB's actions are in clear violation of the terms of the PPA, and Dabhol intends to pursue all available legal remedies under the project documents. Accordingly, Enron does not believe that any contract dispute related to Dabhol would have a material adverse impact on Enron's financial condition or results of operations.[260]

Within three months, the Indian government's actions led the Indian lenders for Phase II to quit funding the project. This in turn caused the contractors to rescind construction contracts. Construction on Phase II of Dabhol again came to a standstill, and the Indian lenders

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[259] SEC App. Tab 1, at 15.

[260] SEC App. Tab 16, at 16.

subsequently assumed control of Dabhol's bank accounts. These are the same contingencies that Enron warned could occur as early as the 1996 Form 10-K -- they had, unfortunately, come to fruition.[261] Importantly, when that happened, Enron again, disclosed these adverse developments in its very next Form 10-Q, for June 2001:

> India. ... Dabhol has been in dispute with the Maharashtra State Electricity Board (MSEB), the purchaser of power from Dabhol, and the Government of Maharashtra (GOM) and the federal government of India (GOI), the guarantors of payments by the MSEB pursuant to the terms and conditions of the power purchase agreements (PPA) and the other project documents. The contract disputes relate principally to (a) the failure by the MSEB to pay certain capacity and energy payments under the PPA, and the failure of the GOM and GOI to satisfy certain guarantee obligations under the project documents and (b) *MSEB's statements that MSEB has "rescinded" the PPA and MSEB is therefore no longer bound by the PPA. As a result of such disputes, the Phase II lenders have stopped funding the continued construction of Phase II and the construction contractors have terminated the construction contracts for non-payment.* There is *no assurance that Dabhol will be able to resolve such disputes to its favor* and to successfully collect on and to enforce any judgment or settlement. However, Dabhol believes that the MSEB's actions are in clear violation of the terms of the PPA, and Dabhol intends to pursue all available legal remedies under the project documents. As a result of these disputes, the 740 megawatt power plant is not being dispatched by MSEB. *Further, Dabhol has suspended construction activity on Phase II.* Enron does not believe that any contract dispute related to Dabhol will have a material adverse impact on Enron's financial condition or results of operations.[262]

Dabhol continued to disintegrate following the government's termination. The Indian government obtained local court orders against Dabhol, and also unilaterally changed its custom duty rates. Enron had earlier warned the public of the possibility of "changes in laws and

[261] As quoted above, Enron specifically warned the public then that the Dabhol project was subject to risks from lack of "availability of project financing" and possible "expropriation of assets."

[262] SEC App. Tab 18, at 10-11.

policies" that might be imposed upon Dabhol and other foreign projects. When that contingency occurred, Enron disclosed that, too. Enron stated in the September 2001 Form 10-Q:

> *Most recently, certain of the Indian financial institutions providing loans to the project have obtained court orders* temporarily preventing Dabhol from terminating the PPA. These same lenders are seeking broader orders requiring Dabhol to restart the power plant pending the resolution of disputes between Dabhol and MSEB. *In addition, the India Commissioner of Customs has recently passed orders adversely altering the custom duty rates applicable to substantial portions of the project* and other rulings detrimental to the project. Dabhol intends to appeal these orders. *Based on the latest developments, Enron cannot predict the outcome of this dispute.* However, the ultimate outcome of these proceedings or negotiations may have a material adverse effect on Enron's financial position and results of operations.[263]

> and:

> Additionally, the lenders to Dabhol have assumed control of Dabhol's bank accounts in order to monitor the use of its remaining available funds. There is no assurance that Dabhol will be able to resolve the disputes with MSEB, GOM and GOI to its favor and to successfully collect on and to enforce any judgment or settlement. ...[264]

The *Newby* Plaintiffs themselves quote the *Wall Street Journal*, which observed that Enron's experience in India "'has emerged as an icon of the challenges facing foreign investors here.'"[265] Key to this, however, is this point: Enron warned investors that these contingencies *could* occur, it provided those warnings beginning as early as the 1996 Form 10-K and continued to do so as the situation deteriorated during the class period. The fact that Enron did not correctly prophesy the future actions of the Indian government, however, is not actionable as a matter of law. *See, e.g., In re Ashanti Goldfields Securities Litigation*, 184 F.Supp. 2d 247, 264

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[263]SEC App. Tab 19, at 32.

[264]*Id.*

[265]NCC at ¶ 600.

(E.D.N.Y. 2001)("Accordingly, complaints alleging securities fraud based on the failure to predict future events have routinely been dismissed.").[266] The above quotations show in exhaustive detail that Enron immediately disclosed the events that caused the eventual shutdown of the Dabhol project as they occurred.[267]

C. ENRON'S FORWARD-LOOKING STATEMENTS REGARDING THE DABHOL PROJECT ARE NON-ACTIONABLE.

To the extent that the *Newby* Plaintiffs point to any actual statement about the Dabhol project, each of them refers to future contingencies and events by "Enron," without any allegation of particularized facts (or clairvoyant powers) possessed by any individual Defendants. Courts have routinely dismissed fraud allegations that are based on vague and general optimistic statements, or on projections of future performance that are not worded as guarantees. The statements quoted by Plaintiffs are not actionable as a matter of law. See *Nathenson,* 267 F.3d at 419 ("it well-established that generalized positive statements about a company's progress are not a basis for liability"). Since the enactment of the PSLRA, the SEC's safe-harbor rules provide additional barriers to lawsuits premised on unspecific, unquantifiable statements of optimism and projections. *Id.*

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[266] *See also Federal-Mogul, supra*, 166 F.Supp. 2d at 565 (argument that a "present-tense statement cannot predict the future" is unpersuasive; truth or falsity is discernible only by future events); *Sakhrani v. Brightpoint, Inc.*, 2001 U.S. Dist. LEXIS 5023 (S.D. Ind. 2001) ("Plaintiffs' unsupported allegations are as consistent with a failure to predict the future accurately as they are with fraud."); *Plevy v. Haggerty*, 38 F.Supp. 2d 816, 828 (C. D. Cal. 1998) ("'Companies are not required to predict the future.'").

[267] Just as importantly, the fact that Plaintiffs *completely ignore* those disclosures is damning to their allegations under the PSLRA, and under Fifth Circuit authority. *See, e.g, Lovelace, supra*, 78 F.3d at 1017.

Here, Plaintiffs quote the following statements by "Enron," each of which is not actionable under the PSLRA as a matter of law:

i) A 1998 Annual Report that stated "'The Dabhol power project ... is expected to be a strong contributor to Enron's earnings in 1999 and beyond.'"[268] As this Court has stated, however, "projections of future performance not worded as guarantees" are not actionable. *BMC*, 183 F.Supp.2d at 888. This Court has noted that even a statement that existing business is "very strong" is too unspecific to support a claim under the PSLRA. *Id.* at 903-04, *passim.*[269] Enron's optimistic and vague opinion that Dabhol would be a "strong contributor" in the future is incapable of objective quantification, and as a matter of law is not actionable as fraud.

ii) The *Newby* Plaintiffs paraphrase opinions that were allegedly given by five individual Defendants at a March 23, 2001 conference call. According to Plaintiffs' paraphrase, those individuals opined that Enron did not feel it was in a "bad position" in India because of its government guarantee and the strength of the contract language, and that Enron was "very confident" it would prevail in that dispute.[270] These paraphrases, however, not only relate to unquoted "vague and optimistic statements of opinion," but also pertain to future contingencies, neither of which is actionable. *Id.* at 888.

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[268]NCC at ¶ 137. Well *after* that prediction, Plaintiffs point out that in November 1999, "rumors circulated" that Enron was having difficulty making its fourth quarter "'numbers' due to problems with Enron's EES and Indian operations." NCC at ¶ 189. "Rumors" by whom, and what did they say specifically? The Complaint again provides no information that even arguably complies with the PSLRA, let alone as to any individual. Instead, this pleading serves only to show that the exhaustive disclosures by Enron about the delays and complete shutdowns in India successfully conveyed the problems to the public.

[269]*See also Fitzer v. Security Dynamics Techs., Inc.*, 119 F.Supp.2d 12, 30-31 (D. Mass. 2000) ("continued market demand," "increasing demand" for defendants' products were puffery and "quite clearly non-actionable"); *In re Mobile Telecomms. Techs. Corp. Sec. Litig.*, 915 F. Supp. 828, 834 (S.D. Miss. 1995) (defendants' statements that they "'[w]e are highly optimistic that we will be profitable in 1993 as demand ... continues to grow,'" and that they "'remain[ed] highly encouraged by the market demand,'" were "too vague and general to provide the foundation for a securities fraud claim").

[270]NCC at ¶ 309. The *Newby* Plaintiffs do not purport to quote the actual words used by either of those five Defendants, Skilling, Rice, Causey, Koenig, or Fastow. 183 F.Supp.2d at 893 ("The majority are paraphrased or excerpted," which is a negative factor under the PSLRA).

Moreover, as quoted above, Enron specifically told the public in the same time period that there was no assurance that it would succeed in resolving the dispute in its favor. In its March 31, 2001 Form 10-Q, Enron stated, "There is no assurance that Dabhol will be able to resolve such disputes to its favor and to successfully collect on and to enforce any judgment or settlement." Even if Enron had provided no such cautionary language, a reasonable investor would not make investment decisions on the assumption that the lawsuits in India, opposite local lenders and contractors, were guaranteed of judgment and collection in favor of the company.

iii) Plaintiffs provide another paraphrase of an alleged statement by "Enron and its bankers" — which is not even assigned either a specific speaker, a date, or even a *year* — that the "worst was over with respect to Enron's Dabhol power plant situation in India."[271] Likewise, it attributes statements to Skilling in July 2001 that "the worst is over in the dispute between Enron's Dabhol Power Co. utility and its sole customer," that he believed "'we're past the high-water mark,'" and that "'We're convinced we'll be paid in full.'"[272]

These are not actionable as a matter of law. In *BMC,* virtually identical statements — that "BMC's troubles were behind it," that its "troubles had been temporary," that its challenges were now "'behind us," that it had a "'spectacular rebound,'" that it was in "much better shape and optimistic" — were not actionable under the PSLRA in spite of their inaccuracy. 183 F.Supp.2d at 869, 878, 892, 904. This Court stated, "Similarly vague expressions of optimism about the future in trying times have been held to be not material, mere puffing, and not actionable under federal securities laws." *Id.* at 892. That especially applies to a statement the truth or falsity of which is "discernible only by future events," as each of these statements of puffery are. *Federal-Mogul Corp., supra*, 166 F.Supp. 2d at 565.

Moreover, in the June 2001 Form 10-Q, Enron had already told the public, "Dabhol has suspended construction activity on Phase II." The lenders had stopped funding the project. The

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271 NCC at ¶ 314.

272 NCC at ¶¶ 330, 337

government had stopped paying under its contract. In Plaintiffs' own words, these statements of optimism" were referring publicly to the "refusal of a state government in India to pay $64 million in power bills"![273] The facts regarding the Dabhol project were disclosed to the public.[274]

D. ENRON'S SPECIFIC WARNINGS OF RISK IN THE INDIAN PROJECT INVOKED THE BESPEAKS-CAUTION DOCTRINE.

Enron's public warnings of risk factors specifically regarding its project in Dabhol also render any general statements of optimism immaterial under the "bespeaks caution" doctrine, and further mandate dismissal of the Complaint.

Under the bespeaks-caution doctrine, the inclusion of meaningful cautionary language in forecasts, opinions, and projections, render alleged omissions or misrepresentations immaterial as a matter of law.[275] *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 548 (8th Cir. 1997). In *Parnes*, the defendants issued a new product lines of computers, and warned investors that

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[273]NCC at ¶ 337.

[274]The Fifth Circuit, in *Nathenson*, cited with approval "*Lasker v. New York Elec. & Gas Corp.*, 85 F.3d 55, 59 (2d Cir. 1996) (observing that 'broad, general statements' are 'precisely the type of "puffery" that this and other circuits have consistently held to be inactionable')." *See also Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1245 (N.D. Cal. 1998) (statement that the defendant was "able to perform two successful acquisitions last year" is immaterial). *See also Grossman v. Novell, Inc.*, 120 F.3d 1112, 1121-22 (10th Cir. 1997) (statements that company experienced "'substantial success' in integrating the sales forces" of two companies, that the merger of the two companies "'was moving faster than we thought,'" and that the companies were "'moving rapidly to a fully integrated sales force,'" were not actionable); *In re Peritus Software Services, Inc.*, 52 F. Supp. 2d 211, 219-20 (D. Mass. 1999) (statement that the company was experiencing "'unprecedented market demand'" for its products was "mere corporate puffery").

[275]Drawing upon Fifth Circuit precedent, this Court has previously noted that "public warnings about risk factors affecting [BMC's] prospects, contained in public filings, stock analysts' reports, and conference calls," rendered BMC's alleged misstatements immaterial. *BMC*, 183 F.Supp.2d at 888, 895 (describing the "bespeaks caution" doctrine). *See also Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 9 (2d Cir. 1996); *Atkins v. Hibernia Corp.*, 182 F.3d 320, 326 (5^{th} Cir. 1999) (cited in *BMC*).

"'There can be *no assurance* that these products or features will be successful.'" 122 F.3d at 549. The Eighth Circuit affirmed the district court's dismissal of the complaint, and stated,

> In light of this *explicit cautionary statement*, no reasonable investor could have been misled that Gateway's new portable products, which represented a small fraction of Gateway's total sales, were anything but a risky venture.

Id. (affirming dismissal and denial of leave to amend).

Here, Enron gave substantially greater warnings to the public than the "no assurance" language that has been held sufficient for dismissal under the PSLRA. As quoted above, Enron warned the public that risks for each of its foreign projects include "without limitation,"

i) the risk of "expropriation of assets" - the government might simply seize property;

ii) the risk of "renegotiation of contracts with foreign governments and political instability" - both of which later happened in spades;

iii) risks over "the receipt of permits and consents";

iv) "the availability of project financing on acceptable terms" - such as when the Indian lenders abruptly quit funding Phase II of Dabhol in 2001;

v) "changes in laws and policies governing operations of foreign-based businesses generally" - such as when the Indian government later changed its custom duty rate;

vi) the descriptions of its projects in India and other nations was "subject to change;"

vii) and as cited frequently above, that other than as noted, "there can be no assurances that these projects will <u>commence commercial operations</u>."

As this parade of horribles occurred in India, and to a lesser extent in Argentina, Enron provided additional cautions as quoted above, pointing out that there was no assurance those disputes would be resolved in Enron's favor.

These warnings are much more detailed than those that have previously been held to satisfy the bespeaks-caution language, and *the warnings fit with what in fact occurred in the* *ensuing years of the projects*. Moreover, these warnings supplement the "basic assumption" of the public regarding the inherent uncertainty and risk involved with investment in an emerging nation. Economic uncertainty, political turbulance, and similar inherent risks, are a "basic assumption" in contracts to be performed in emerging nations.[276] Enron's statements, elaborating on what the public is already deemed to know about the Dabhol project, are entitled to safe harbor protection.

E. STATEMENTS IN ANALYSTS' REPORTS CONCERNING THE DABHOL PROJECT ARE NOT ACTIONABLE AGAINST THE INDIVIDUAL DEFENDANTS

In Paragraphs 69, 142, 169, 178, 190, 273, 279, 327, 330, 337, and 600 of the Complaint, the *Newby* Plaintiffs paraphrase or quote from various newspapers and periodicals that make reference to the Dabhol project. Only three of those articles purport to quote and identify one of the individual Defendants;[277] those vague statements of optimism for the future are already quoted and discussed above, and are non-actionable as a matter of law.

The remainder also fail to state a claim under the PSLRA against movants. First, there is no pleading, whatsoever, to show that any individual Defendant "controlled" the contents of reporting by the outside authors referenced in those paragraphs: *Newsweek*, Merrill Lynch, CitiGroup, JP Morgan, *Bloomberg News*, *Dow Jones Energy Service.* This Court stated in *BMC*:

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[276]For example, the Fourth Circuit rejected a frustration-of-contract argument, and stated that "sales to developing countries are inherently risky, especially in Latin America and South America. It does not, therefore, appear that the non-occurrence of political turbulence resulting in economic uncertainty for exporters would reasonably have been a basic assumption upon which the contract was based." *Coker Int'l, Inc. v. Burlington Indust., Inc.*, 1991 U.S. App. LEXIS 11794 (4th Cir. 1991) (unpublished).

[277]NCC at ¶¶ 178, 330, and 337 each purport to quote Skilling.

> This Court agrees with the majority view that there must be alleged facts showing some involvement in and control over the content of the analysts' reports by the defendants to hold them liable for misleading statements made in those reports.

183 F.Supp.2d at 871 n.21; *id.* at 893 ("Plaintiffs have pled no facts demonstrating that Defendants exercised control over any of the analysts' comments."); *Raab,* 4 F.3d at 288 (cited in *BMC* for the proposition that "Defendants are not responsible for comments of independent analysts that they do not control and have no duty 'to police statements made by third parties for inaccuracies, even if the third party attributes the statement' to a Defendant."). Here, there is no *mention* of the individual Defendants in connection with these publications, let alone allegations that they had any involvement and "control" over the contents. Those allegations should be dismissed under the PSLRA.

2. PLAINTIFFS' ALLEGATIONS OF "SNOWBALLING" ARE BASELESS.

Plaintiffs' allegations that Enron or Enron International "snowballed" expenses must also be dismissed. It is undisputed that Enron capitalized start-up expenses, and that it routinely disclosed this accounting practice in its publicly filed financial statements.[278] Capitalization of start-up expenses *was permitted by GAAP*,[279] and Plaintiffs have not alleged that it was improper. Rather, they claim that some of those expenses should have been written off sooner — although they do not say what expenses, or how much, or why, or when, or which GAAP accounting principle allegedly required an earlier write-off.

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[278]Enron routinely disclosed that it was capitalizing development costs for startup expenses. For example, the 1997 Form 10-K includes the following disclosure:

> Accounting for Development Activity. Enron capitalizes project development costs which may be recovered through other third parties, written off against development fees received or included as part of an investment in those ventures in which Enron continues to participate. Accumulated project development costs are otherwise expensed in the period that management determines it is probable that the costs will not be recovered. SEC App. Tab 2, at 79.

[279]*See Statement of Position 98-5, Reporting on the Costs of Start-Up Activities*, American Institute of Certified Public Accountants ("AICPA") Official Release, 7-98 J.A. (Journal of Accountancy) 95 (July, 1998) (Requiring, for the first time, that start-up and organizational costs be expensed as incurred, beginning with financial periods after December 1998.).

The mere publication of allegedly inaccurate accounting figures, or an alleged failure to follow GAAP, without more, does not establish a cause of action for securities fraud. Here, though, Plaintiffs fail to plead facts to show that the accounting for start-up expenses was even <u>in error</u>. They cite no GAAP principle, which existed prior to the adoption of SOP 98-5 and Enron's write-down, that dictated an accounting treatment other than the one Enron used <u>and disclosed</u>. More importantly, they plead no facts to show that any *individual Defendant* knew that Enron was publishing allegedly false and material information through the timing of its write-downs of alleged "snowballed" expenses, or was severely reckless in publishing such information, if they knew. These allegations must be dismissed. *Lovelace, supra*, 78 F. 3d at 1020-21 & n. 7; *DiLeo,* 901 F. 2d at 626-27.

The *Newby* Plaintiffs make two general allegations relating to "snowballing," which are repeated almost verbatim throughout the Complaint as "true but concealed facts":

i) First, they claim that Enron's 1997 and 1998 financial statements allegedly violated unspecified principles under GAAP, by continuing to carry certain unspecified start-up expenses as assets on the balance sheet rather than having expensed them "between 93 and 97";

ii) Second, they admit that Enron took (and disclosed) a $131 million cumulative charge for start-up expenses in Q1 1999, thereby eliminating the allegedly misleading balance sheet entries. Plaintiffs argue, however, that Enron stated that the charge was the result of a change in accounting standards (Statement of Position 98-5, which is quoted immediately above in note). They claim that this description of the reason for the write-off was misleading, but do not identify any specific information that was allegedly omitted.[280]

[280]NCC at ¶¶ 121, 155(k), and 581. The same allegation is again made yet again, in conclusory form and without any supporting facts, in NCC at ¶¶ 155(j), 214(o), and 580-81. In NCC at ¶ 580-82, Plaintiffs recognize that Enron wrote off the full amount of these start-up expenses in the 1stQ 1999 and disclosed that it was doing so.

These allegations wholly fail to state a cause of action for fraud against Enron, let alone any of the individual Defendants. They fail to "specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made,[281] and explain why the statements were fraudulent," as required in order to survive a motion to dismiss. *Nathenson*, 267 F.3d at 407-08. The Complaint also fails to plead the specific statements alleged to have been misleading, and the reason or reasons why the statements allegedly are misleading, in conformance with 15 U.S.C. §78u-4(b)(1) and (2).

The *DiLeo* decision, discussed earlier involved a similar allegation that accountants committed securities fraud by failing to write down bad loans at an earlier date, allegedly in violation of GAAP. *DiLeo*, 901 F.2d at 626-27. Losses were allegedly "understated by approximately $4 billion" in bad loans. In order to properly allege fraud based on an alleged GAAP violation involving the timing of a write-down of expenses, the plaintiff must plead specific "who, what, when, where, and how" facts to establish the defendant's knowledge of problems with the business that were so apparent that writeoffs should have been taken earlier:

> If all that is involved is a dispute about the timing of the writeoff, based on estimates of the probability that a particular debtor will pay, we do not have fraud; we may not even have negligence.

901 F.2d at 627 (affirming dismissal for failure to plead fraud with sufficient particularity); *see also K-Tel*, 107 F.Supp.2d at 1001 ("Plaintiffs may not simply rely on the timing of a write-off.").

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[281]Prior to the alleged class period, Plaintiffs state that an unidentified "international accounting officer" told Causey, on some unspecified date, that a write-down had to be taken. *See, e.g.*, NCC at ¶ 121. They make no reference to when this supposedly occurred, in relation to when they concede Enron did take the write down in the first quarter of 1999. Likewise, they claim that Enron International was "[u]nder Mark-Jusbasche." *Id.* The allegation that she held a high position in the company is incompetent to state a claim. *BMC*, 183 F.Supp.2d at 915-16; *id.* at 886 n. 34 (quoting *Kurtzman*).

Here, Plaintiffs not only fail to provide any such details, but their own pleadings belie their claims. In connection with Dabhol, for instance, they acknowledge that Enron did *not* abandon its $300 million investment after the first 1½-year construction delay, that it "envisioned" certain high rates, and continued developing it into late 2001. In the *Newby* Plaintiffs own words,

> The problem was that the rates envisioned for consumers in India were several times higher than other rates in the country. Additionally, Enron continued to have regulatory/political problems in finalizing the project.[282]

These allegations do not show that Enron's decision to complete the project, and not to write it off, constituted accounting fraud. Nor would the allegation make sense: if Enron concluded that the project should be abandoned, its efforts to renegotiate and to arbitrate, and its actual completion of Phase I, are completely inconsistent with an intent to abandon or write off the project.

Likewise, Plaintiffs must identify the assets that allegedly should have been written off, and the factual basis for their allegation that the assets were impaired.[283] The Complaint, however, is devoid of such facts. In contrast to these requirements, the *Newby* Plaintiffs plead in the most vague and conclusory fashion — in three separate places — that "[c]osts for South African projects involving oil and gas reserves, pipelines, and a plant designed to convert ore

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[282]NCC at ¶¶ 598-99.

[283]*In re K-Tel International, Inc. Securities Litigation*, 107 F. Supp. 2d 994, 1000, 1001 (D. Minn. 2000) (plaintiffs failed to identify "which assets or identifiable intangibles are implicated," failed to "'estimate the future cash flows expected to result from the use of the asset and its eventual disposition' or to show that the sum of the future cash flows is less than the carrying amount" in accounting records, failed to allege "the basis for concluding that a review for impairment as not performed.").

into another form of energy, and projects in China, among others, were 'snowballing' quickly."[284] In the same three paragraphs, they add only that the "snowball" encompassed "some 75 projects, including those in Central and South America and the Dabhol power plant in India."

In short, Plaintiffs fail to provide details as to *what* expenses are referred to. They refer only to unspecified "costs" and "expenses." They fail to state details of each asset that allegedly was impaired (let alone identify them). They fail to identify each asset that should have been written off, and specifically when and why. They fail to plead facts to show who-what-when-where as to each individual Defendant. In fact, except as to Dabhol, they do not even identify the projects which allegedly held impaired assets (*e.g.*, "projects in China," "some 75 projects"), describe why they supposedly failed, or explain how any individual Defendant supposedly knew of these alleged impairments and how they were being treated on ledgers. The pleading makes a mockery of the PSLRA requirements.

The Complaint's conclusory allegation that $100 million in assets should have been written off sometime between 1993 and 1997, instead of early 1999, is not sufficient. *See DiLeo*, 901 F.2d at 267. Plaintiffs must plead pertinent facts, including particular transactions as well as the underlying basis for any figures asserted by them, demonstrating that the specified accounting principle applies and how it was violated. *K-Tel*, *supra*, 107 F. Supp. 2d at 999. To survive a motion to dismiss, allegations of securities fraud based on violation of GAAP must include specific information, such as the approximate amount by which revenues and earnings were overstated, the products involved, the dates of the transactions, and the identities of the persons involved. *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 203-204 (1st Cir. 1999);

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[284] NCC at ¶ 121(f), 155(k), 581.

Sakhrani v. Brightpoint, Inc. 2001 U.S. Dist. LEXIS 5023 (S.D. Ind. 2001)(company wrote off unamortized pre-operating and organizational expenses upon adoption of SOP 98-5; complaint alleging that write-off should have been taken earlier dismissed for failure to plead facts to support alleged violation of SEC or GAAP guidelines).

The Complaint also must be dismissed because it fails to plead specific facts giving rise to a "strong inference" of scienter: as it pertains to the timing of write-offs.

As stated in *DiLeo:*

> For any bad loan comes a time when the debtor's failure is so plain that the loan is written down or written off. No matter when a bank does this, someone may say that it should have acted sooner. If all that is involved is a dispute about the timing of the writeoff, based on estimates of the probability that a particular debtor will pay, we do not have fraud; we may not even have negligence.

DiLeo, 901 F. 2d at 627. Similar reasoning should apply to disputes concerning the timing of write-offs of capitalized expenses based on estimates of the probability that a particular project will succeed: such allegations do not amount to fraud. The only "snowballed" project that Plaintiffs actually name — Dabhol — continued to develop until the triple blow of the construction walkoffs, Indian lender actions, and refusals to pay -- all of which occurred in late 2000 and during 2001. More importantly, the Complaint fails to state any facts to show why it was a mistake - let alone a knowing or severely reckless act - for any of the individual Defendants to fail to conclude that it was probable that the costs of any particular project proposal would not be recovered. Aside from Plaintiffs' failure to identify any misstatements relating to "snowballing," their allegations should be dismissed because any alleged misstatements would be rendered immaterial by Enron's disclosures about its capitalization of expenses, and its subsequent write-off of those expenses following a change in accounting policy.

Plaintiffs complain that Enron's 1997 and 1998 financial statements should not have included some portion of the capitalized development expenses as an asset.[285] However, Enron routinely disclosed that it capitalized expenses. After the adoption of SOP 98-5, and prior to commencement of the alleged class period, Enron promptly and repeatedly disclosed that, due to a change in accounting policy, it anticipated that it would have to write off certain development expenses that it previously had capitalized.[286] (Plaintiffs point to no such requirement prior to SOP 98-5.) Enron disclosed that it estimated that the amount of the required cumulative charge would be $100 million.[287] Enron's 1998 Form 10-K again cautioned that the company would be taking a charge against earnings reflecting cumulative expenses of development, and it increased the estimated amount of the anticipated write-off to $130 million. In the first quarter of 1999, Enron wrote off previously capitalized development expenses (the ones that Plaintiffs claim had been improperly "snowballed"). Enron disclosed the $131 million write-off and disclosed that it

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[285]These financial statements fall largely *outside* the claimed class period, which begins in October of 1998, NCC at ¶ 2, so they are irrelevant to any issue in this case.

[286]AICPA adopted SOP 98-5 in April 1998. In the first Form 10-Q that it filed after adoption of this policy — before the alleged class period – Enron disclosed:

> On April 3, 1998, the AICPA issued Statement of Position 98-5 (SOP 98-5), "Reporting on the Costs of Start-Up Activities" which generally requires that costs of start-up activities and organization costs should be expensed as incurred. SOP 98-5 is effective for financial statements for fiscal years beginning after 1998 and initial adoption is required to be reflected as a cumulative effect of accounting change. Enron is evaluating the impact of SOP 98-5 and is currently unable to estimate the impact of adopting this accounting pronouncement.

SEC App. Tab 3, at 21; *see also,* SEC App. Tab 4, at 34.

[287]SEC App. Tab 5, at 38 ("...Enron is evaluating the impact of adopting SOP 98-5, and it expects to recognize an after-tax charge of approximately $100 million in the first quarter of 1999. This charge will be reflected net of tax as a separate line item above net income.").

was attributable to the expensing of cumulative development costs, in its March 1999 Form 10-Q[288] and in each subsequent 10-Q and 10-K report in 1999.[289]

These disclosures render any alleged misstatements concerning snowballing immaterial to any subsequent decision to purchase Enron's securities. *Rand v. Cullinet Software, Inc.* 847 F. Supp. 200, 205-207 (D. Mass. 1994)(no material misstatement when market had information showing Defendant's performance was affected by factors other than the one that it blamed for its operating result); *Atkins v. Hibernia Corp.*, 182 F. 3d 320, 326 (5th Cir. 1999)(where a public document fully discloses information material to the allegedly concealed matter, dismissal is appropriate under Rule 12(b)(6)). Prior to the commencement of the alleged class period, Enron had already disclosed that it could be required to write-off development expenses in Q1 1999.[290] Within a month after the commencement of the Class Period, Enron's publicly filed disclosure documents clearly stated that Enron intended to take a write-off for cumulative development expenses totaling $100 million - the full amount of the write off that Plaintiff says Enron should have taken earlier. No accounting rule previously required it to do so. Any subsequent reliance of any purchaser of securities on statements previously made about development expenses would have been misplaced.

Plaintiffs acknowledge that the write-off was taken and disclosed. They do not quarrel with the amount of the write off, but claim that the reason given — the adoption of SOP 98-5 as part of GAAP, and the consequent requirement that all development costs be expensed as

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[288]SEC App. Tab 7, at 7.

[289]SEC App. Tabs 8, at 7; 9 at 8; 11, at 35; 10 at 47, 102.

[290]SEC App. Tab 3, at 21.

incurred — was misleading.[291] Even if this allegation were supported by facts, which it is not, the reason given for the write-off would be immaterial: the public was informed of over $100 million in write-offs.

The amount of the accumulated expenses, the fact that they were attributable to development expenses that earlier had been capitalized, Enron's plans to write them off, and the write-off immediately after the effective date of SOP 98-5, were all clearly disclosed to the public. Plaintiffs do not state what other material information they think Enron should have added to this disclosure, or that any individual Defendant knew it. The Complaint's allegations relating to the "snowballing"/capitalizing of development expenses should be dismissed.

3. PLAINTIFFS' ALLEGATIONS REGARDING ENRON'S EFFORT TO ENTER THE GLOBAL WATER BUSINESS AND AZURIX CORP. ARE NONACTIONABLE UNDER THE PSLRA.

A. PLAINTIFFS' CONCLUSORY ALLEGATIONS ABOUT THE WATER VENTURE FAIL TO ALLEGE SCIENTER ON THE PART OF ANY INDIVIDUAL DEFENDANT.

Plaintiffs also argue that Defendants engaged in fraud in connection with Enron's efforts to establish a new business line privatizing water distribution and supply. Those efforts resulted in the subsequent IPO for Azurix Corp.[292] Plaintiffs allege that throughout 1998-99, "Enron, it lawyers [sic] and Enron's banks" stated that "Wessex Water would be accretive to Enron's business now and a $20 billion business in five years."[293] Plaintiffs provide no identification of any speaker, any source, any dates, or any specific statement predicting Wessex as "a $20 billion

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[291]NCC at ¶¶ 580-582.

[292]NCC at ¶14(a); ¶121(h); ¶136, ¶139, ¶155(n); TCC at ¶¶ 389-396

[293]NCC at ¶14.

business in five years." They do not attribute this statement to any individual Defendant. Plaintiffs also complain:

> In truth, Enron grossly overpaid for Wessex Water – hundreds of millions of dollars more than the company was really worth. The business would hurt, not help, Enron's earnings, would result in a later writedown of that overvalued asset, and would not become a $20 billion business in five years. Enron created the purported worldwide-water business without any adequate feasibility study or the creation of any detailed business plan, thus rendering the venture one of extraordinarily high risk that defendants knew was unlikely to generate profits or adequate returns going forward.[294]

Plaintiffs never identify which Defendants knew Wessex was "unlikely to generate profits or adequate returns going forward," or when or how these unidentified defendants came to know it — or how any such information is known to Plaintiffs. No detailed pleading of the individual Defendants' alleged involvement or their knowledge of any undisclosed facts appears on the face of the Complaint. Plaintiffs fail to allege "what actions each Defendant took in furtherance of the alleged scheme and specifically plead what he learned, when he learned it, and how Plaintiffs know what he learned." The Complaint, again, is facially defective. *BMC*, 183 F.Supp.2d at 886.

The *Newby* Plaintiffs further complain:

> Enron had grossly overpaid for Wessex water...which Enron knew meant it would not be accretive to Enron but, in fact, would result in a later writedown of that overvalued asset.[295]

Complaints that "Enron knew" that Wessex "would not be accretive to Enron but...would result in a later writedown" completely fail to meet PSLRA requirements of particularized allegations

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[294]NCC at ¶121(h).

[295]Plaintiffs recite the same charge in NCC at ¶121(h), purportedly relating to pre-Federal Class Period statements including the July 24, 1998 press release, and at ¶155(n), relating to the statements made between 10/21/98-7/6/99.

of fraud.[296] Plaintiffs likewise fail to explain their unfounded suggestion that Enron would make this multi-billion dollar investment if it expected it to fail at a "later" date.[297] Their unparticularized and conclusory allegations fail to even minimally satisfy PSLRA standards. Plaintiffs further argue, in conclusory fashion and without supporting facts, that "Enron created the purported worldwide-water business without any adequate feasibility study or the creation of any detailed business plan."[298] Even if this conclusion were to be dressed with alleged facts, it fails to state any claim for *fraud*, or even negligence.

> Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.

Santa Fe Industries, Inc., 430 U.S. at 478. In reality, this pleading is "nothing more than conclusory disparaging characterizations" which are nonactionable as a matter of law. *Tuchman*, 14 F.3d at 1070. Plaintiffs also identify no specific "inadequacy" of any feasibility study, or any omitted "detail" of any business plan. Based on its wording ("Enron created" the water company without a plan), this allegation appears to refer to Enron's 1998 acquisition of Wessex, not to the later Azurix IPO, but Plaintiffs leave that to guesswork. In an exhaustive 62-page Memorandum and Order, Judge Sim Lake has already dismissed with prejudice PSLRA claims that Azurix

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[296]Plaintiffs' allegation in NCC at ¶ 593 that "Enron failed to adequately disclose" the debt capitalization structure of Marlin Water Trust" fails for the same reason.

[297]*See Laro*, 866 F. Supp. at 137-38 (dismissing claim that rested on unreasonable inference that defendant would "intentionally . . . act[] in such a way as to cause itself losses which were enormous even for such a large financial institution.

[298]Plaintiffs recite the same allegation in NCC at ¶121(h), purportedly relating to pre-class statements, but without referencing any specific statement or facts, and at ¶155(n), again without referencing any specific statement or facts. A similar allegation appears at ¶590 ("Enron created this purported worldwide water business without adequate feasibility studied [sic] and without a detailed business plan.").

inadequately disclosed risk of the new IPO venture, citing the clear disclosures of business, political and regulatory risk in the Prospectus (*see infra*).

Furthermore, the Azurix Prospectus itself belies Plaintiffs' allegation that there was no feasibility study or business plan. It discloses extensive discussion of factors affecting the proposed business, provides detailed explanations of the proposed business opportunities, and warns in detail about risk factors facing the new venture. SEC App. Tab 93, at 6-9, 20-21, filed March 15, 1999, providing analysis of "Our Company," "Our Industry," "Our Competitive Strengths," "Our Business Strategy," at 6-9, and "Risk Factors," at 12-19, "Cautionary Statements Regarding Forward-Looking Statements," at 20-21; *see also* "Management's Discussion and Analysis of Financial Condition and Results of Operations," to be read in conjunction with the incorporated financial statements, at 26-37. *See also* "Government Outsourcing Through Privatization," which outlines the business plan, reviews upcoming water and wastewater privatizations globally, as well as outsourcing opportunities in the municipal and industrial services markets, analyzes competitive strengths, addresses regulatory, operating and financing expertise, and discusses business strategy, at 37-69. "Investors must point to some facts" attributing financial problems to fraud. *DiLeo*, 901 F.2d at 627.[299] Plaintiffs point to <u>no</u> facts here. Even assuming *arguendo* that feasibility studies and business plans were not adequate,

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[299]*See Trump*, 793 F. Supp. at 557, holding that no reasonable inferences of fraud could be drawn from plaintiffs' conclusory allegation, devoid of factual basis, that there was "no reasonable basis" for as prospectus statement that management believed operating funds would be adequate to cover debt service:

> The complaint itself dictates this interpretation of plaintiffs' claim. Plaintiffs' allegation of "no reasonable basis" is a naked assertion unsupported by any factual allegations in the complaint. Plaintiffs provide no foundation for their assertion that defendants either had no reasonable basis for its belief, or that defendants did not in fact hold that belief.

"Corporate mismanagement does not, standing alone, give rise to a 10b-5 claim, and mea culpa does not sufficiently satisfy the scienter requirements of pleading in securities fraud cases ...." *Tuchman*, 14 F.3d at 1061. Nor do Plaintiffs allege scienter on the part of any individual Defendant. Instead, they take refuge in soap-opera innuendo, alleging that the water business was established merely to settle a dispute between Skilling and Mark-Jusbasche, to allow Mark-Jusbasche to "fulfill her ambition to be CEO of a public company," and "to silence Mark-Jusbasche, who possessed extraordinarily dangerous and damaging information about the wrongdoing" about Enron. [300] What "dangerous and damaging information?" What "wrongdoing?" In all 800 pages of the Complaint, the *Newby* Plaintiffs provide not one substantiating fact to support these conclusory statements.

Indulging in such tactics, Plaintiffs violate the "first step for a Rule 10b-5 plaintiff" which is to establish that defendant made a materially false or misleading statement or omitted to state a material fact.

Plaintiffs' scandal-sheet approach also does not satisfy the PSLRA requirements. They do not "state with particularity <u>facts</u> giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Nor do they satisfy the requirement of Rule 9(b) that circumstances constituting fraud or mistake shall be "stated with particularity." The Complaint contravenes important policy reasons when it substitutes headlines for <u>facts</u>:

> In securities fraud suits, this heightened pleading standard provides defendants with fair notice of the plaintiffs' claims, protects defendants from harm to their reputation and goodwill, reduces the number of strike suits, and prevents plaintiffs from filing baseless claims and then attempting to discover unknown wrongs.

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[300] NCC at ¶121(h).

Tuchman, 14 F.3d at 1067 (citing *Shushany v. Allwaste, Inc.*, 992 F.2d 517, 521 (5th Cir. 1993); *Cosmas v. Hassett*, 886 F.2d 8, 11 (2d Cir. 1989).[301]

Certainly, the *Newby* Plaintiffs fail to allege scienter on the part of any individual Defendant of any facts which could transmute these generalized "soap opera" allegations into the basis for a PSLRA claim. Furthermore, Plaintiffs' allegation that Lay, Mark-Jusbasche and Skilling were acting "not only in their capacity as officers and/or directors of Enron, but also in their capacities as officers or directors of Azurix"[302] is also an insufficient basis for scienter. Mere position with a company does not suffice to create an inference of scienter. *Nathenson*, 267 F.3d at 424 (citing *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994), and *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999)).[303] *See also BMC*, 183 F.Supp.2d at 915 ("this Court has previously rejected just such vague pleading as insufficient" under the PSLRA [attributing fraud to defendants based on high positions]).

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[301]*See Lovelace*, 78 F.3d at 1020 ("Plaintiffs' bare allegation about industry custom is precisely the type of conclusory allegation that motivated the heightened pleading standards of Rule 9(b) in the first place.") (citing *Tuchman);* similarly, *see In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1418 (3rd Cir. 1997) (goals of Rule 9(b) include "the deterrence of frivolous litigation based on accusations that oculd hurt the reputations of those being attacked").

[302]NCC at ¶83(gg).

[303]As explained in *Advanta*, *supra*, 180 F.3d at 538, the allegation that a securities-fraud defendant "must have known" a statement was false or misleading because of his position within the company is "precisely" the type of inference which courts have repeatedly found inadequate under Rule 9(b), citing *Rosenbloom v. Adams, Scott & Conway, Inc.*, 552 F.2d 1336, 1338-39 (9th Cir. 1977) ("A director, officer, or even the president of a corporation often has superior knowledge and information, but neither the knowledge nor the information necessarily attaches to those positions.").

The Complaint makes no reference to any facts showing scienter on the part of these or any other individual Defendant as to these or any other allegations involving Azurix. The *Newby* Plaintiffs' failure to plead "the first step" - an actionable misrepresentation or omission - or the second step - scienter - mandates dismissal. *Lovelace*, 78 F.3d at 1017.

B. ENRON'S FORWARD-LOOKING STATEMENTS REGARDING THE WATER BUSINESS ARE NONACTIONABLE.

The *Newby* Plaintiffs complain of Enron's July 24, 1998 press release on the Wessex acquisition, but completely omit cautionary language in the same document which referred to its "forward-looking statements." Plaintiffs quote the following *portions* of the press release:

> 'The new company is expected to be accretive to Enron's financial results in the first full year of operations, and we intend to pursue a strategy such that the new water company will be accretive in the future,' Lay said.
>
> * * *
>
> 'Wessex will be the flagship of the new water company,' Lay said. 'As such, Wessex will be the center of excellence for the new international water business . . . .'[304]

Plaintiffs complain, without facts, that "Enron knew" that the new water business "was not becoming a major global water company nor was it accretive to Enron's earnings."[305]

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[304]NCC at ¶ 114; The Newby Plaintiffs also quote an interview with Kenneth Lay the very same day in *Bloomberg News*:

> Ken Lay, Enron's chairman, said in an interview he expects the new company to become 'the leading global water company.' He expects the water business to be of comparable size to Enron's multibillion dollar electricity and gas businesses 'within five years or so.'

[305]NCC at ¶ 155(n).

Tellingly, though, they *completely ignore* the cautionary language *in the same press release*[306] which explicitly addresses the forward-looking nature of the statements and the risks concerning the new company's ability "to become a strong competitor in the global water industry":

> This press release includes forward looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Although Enron believes that its expectations are based on reasonable assumptions, it can give no assurance that its goals will be achieved. Important factors that could cause actual results to differ materially from those in the forward-looking statements herein include political and regulatory developments affecting Wessex, the level of Wessex's capital expenditures, the availability of new acquisition opportunities, the timing and success of future acquisitions and conditions of the capital markets and equity markets during the periods covered by the forward looking statements.[307]

Indeed, the same press release specifically and directly addressed whether the water business would be "accretive to earnings," warning that Enron's post-Wessex future earnings per share would not necessarily increase:

> Any statement relating to improvements in financial results is made prior to considering any synergy or other benefits that the acquisition of Wessex may give rise to, and *should not be interpreted to mean that the future earnings per share of Enron, as enlarged by the acquisition of Wessex, will necessarily be greater than the historical earnings per share of Enron.*[308]

The *Newby* Plaintiffs also omit from the Complaint language in the same press release in which Enron specifically and directly addressed, and publicly disclosed, Enron's alleged

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[306] This Court has recognized that it may consider the full text of documents that are partially quoted or referred to in the complaint. *BMC*, 183 F.Supp.2d at 882(*citing Phillips v. LCI Intern., Inc.*, 190 F.3d 509, 518 (4th Cir. 1999); *Harris v. Ivax Corp.*, 182 F.3d 799, 802 n.2 (11th Cir. 1999); *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 808-09 (2d Cir. 1996)).

[307] App. Tab 10, at 4.

[308] *Id.*

"overpayment" for Wessex, expressly explaining that Enron had made an all-cash offer with a substantial – 28 percent – premium for Wessex, in order to get into the water business:[309]

> As a key step in establishing this new business, Enron announced an all cash offer, which has been unanimously recommended by the board of directors of Wessex Water Plc ('Wessex') for all outstanding common shares of Wessex. The offer, which will be made by a subsidiary of Enron, will be made on the basis of £6.30 (US $10.33) for each share and values the common equity of Wessex, on a fully diluted basis, at approximately £1.4 billion (US$2.2 billion). The offer represents a 28 percent premium based on Wessex's closing price of £4.93 (US$8.08) per share on July 23, 1998.'

Thus Plaintiffs complain that Enron concealed what it in fact disclosed: It "overpaid" for Wessex by paying a 28% premium, equivalent to $616,000,000. This does not state a claim of fraud.[310]

The *Newby* Plaintiffs also complain of an interview with *Bloomberg News* on the same date as the July 24, 1998 press release which reported:

> Ken Lay, Enron's chairman, said in an interview he expects the new company to become 'the leading global water company.' He expects the water business to be of comparable size to Enron's multibillion dollar electricity and gas businesses 'within five years or so.'[311]

Such a statement, if accurately quoted (Defendants have not located this interview in the *Bloomberg News* archives), is classic non-actionable corporate optimism. *See, e.g., Nathenson,* 267 F.3d at 417 n.15 (terming non-actionable corporate puffery, and "at most mere optimistic generalization," a pharmaceutical company's statements that clinical trials had "positive results"

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[310] Indeed, Enron disclosed this in much greater detail than Plaintiffs do in the Complaint, disclosing the per-share purchase price, and Wessex's current share price. Importantly, the public had this detailed information on the Wessex acquisition months before the alleged class period began.

[311] NCC at ¶115.

and were "successful"). The CEO's statement of his expectations for the new company five years in the future - clearly a forward-looking statement - was not worded as a guarantee and no reasonable investor would rely on such an expression of optimism. "[M]isguided optimism, is not a cause of action .... People in charge of an enterprise are not required to take a gloomy, fearful or defeatist view of the future." *In re Carter-Wallace, Inc. Sec. Litig.*, 220 F.3d 36, 42 (2d Cir. 2000).

The "bespeaks caution" doctrine protects just such optimistic projections. Warnings about the risk factors affecting the water company's prospects, including the press release of the very same date as the Lay interview, render immaterial any alleged misstatement. *Atkins v. Hibernia Corp.*, 182 F.3d 320, 326 (5th Cir. 1999) (plaintiffs fail to state a securities violation where a public filing discloses all the information material to the alleged misrepresentation or omission)) cited in 183 F.Supp.2d at 888 n.37.

Moreover, even if the cautionary language of the same-day Enron press release did not apply to this newspaper article,[312] Plaintiffs fail entirely to allege how this statement was false when made on July 24, 1998, or that the defendant made the statement with "actual knowledge"

[312]This statement apparently comes from a newspaper article written by someone other than Enron, so it does not create PSLRA liability. *BMC*, 183 F.Supp. at 871 n.21 ("Generally a company has no liability for misleading claims made about it by an independent third party and no obligation to correct statements made by outsiders."). Newby's use of a newspaper report raises evidentiary issues and is not sufficient to give rise to a strong inference of severe recklessness. *See In re Republic Services, Inc., Sec. Litig.*, 134 F.Supp.2d 1355, 1361 (S.D.Fla. 2001) (newspaper article containing alleged quote from company representative was insufficient to create the requisite "strong inference" under the PSLRA); *In re Technical Chemicals Sec. Lit.*, 2001 WL 543769, *8 (S.D.Fla. March 20, 2001) (statement that system "will ...[be] on the market by late 1998 or early 1999" is forward looking, and the absence of explicit cautionary language in a newspaper article does not eliminate PSLRA safe harbor for such quotations; document is not a company document subject to editorial control).

that it was "false or misleading." 15 U.S.C. § 78u-5c(1)(B). In order to satisfy Rule 9(b) in connection with a Rule 10b-5 claim, Plaintiffs must show, *inter alia*, a misrepresentation of material fact and knowledge by the defendant of its falsity. *In re Westinghouse Sec. Litig.*, 90 F.3d at 710. The facts, as alleged, are insufficient to form the basis for such a belief on the part of the purported speaker or any other defendant, particularly since the truth or falsity of the belief could only be determined based on future events. *See In re Peritus Software Services, Inc. Sec. Litig.*, 52 F.Supp.2d 211, 229 (D.Mass. 1999) (holding non-actionable statements about the success of a merger a few months before it occurred which "therefore could not have been made with knowledge or reckless disregard of their false or misleading nature").

The same analysis renders non-actionable Plaintiffs' complaint about each of the following statements in Enron's 98 Annual Report concerning New Businesses and Azurix:

Enron has a long history of starting and successfully building new businesses.....

> We think ... [Broadband and Azurix] have tremendous potential and could be significant contributors to the value of our stock in the next couple of years.[313]
>
> ii)Azurix is poised to become a major global water company in a $300 billion market that is ripe for third-party investment and the modernization of water and wastewater infrastructure...Azurix's participation in the full spectrum of these areas will allow it to create enhanced value for shareholders.[314]

As this Court has stated, "projections of future performance not worded as guarantees" are not actionable. *BMC*, 183 F.Supp.2d at 888. Enron's general and optimistic opinions that Azurix is "poised"to become a major global water company," that it has "tremendous potential" and "could be" a significant contributor to Enron stock are corporate puffery, incapable of

[313]NCC at ¶136.

[314]NCC at ¶139.

objective quantification[315] and non-actionable as a matter of law. These statements, like the press release and *Bloomberg News* article, are non-actionable as a matter of law. 183 F.Supp.2d at 888.[316]

In addition, the *Newby* Plaintiffs allege but plead no facts to show specifically how the statements quoted above were untrue *when made* in March 1999. These statements provide no basis for a claim under the PSLRA.

C. ENRON'S SPECIFIC WARNINGS OF RISKS IN THE WATER VENTURE INVOKED THE FORWARD-LOOKING AND BESPEAKS-CAUTION DOCTRINES. JUDGE SIM LAKE HAS ALREADY DISMISSED WITH PREJUDICE PSLRA CLAIMS CONCERNING THE AZURIX IPO BASED ON THE PUBLIC DISCLOSURES MADE.

The *Newby* Plaintiffs also ignore Enron's contemporaneous public disclosures of risk factors regarding the proposed water business, as well as Enron's and (following the June 1999 Azurix IPO) Azurix's public filings, which drew specific attention to forward-looking statements and identified meaningful risks and uncertainties involved in its entry into this new market.

At the very time Wessex was acquired, Enron's press release warned that "**it can give no assurance that its goals will be achieved**" for the new water company, and warned the public of specific risk factors that could cause the water company's actual results to differ materially from the forward-looking statements in the press release, including political and regulatory

[315] *See, e.g., In re Nice Systems, Ltd. Sec. Lit.*, 135 F.Supp.2d 551, 579 (D.N.J. 2001) ("'[S]tatements of subjective analysis or extrapolation, such as opinions, motives and intentions' are 'soft information' and hence immaterial for purposes of Rule 10b-5.") (quoting *In re Craftmatic Sec. Litig. v Kraftsow*, 890 F.2d 628, 642 (3d Cir. 1989).

[316] *See Advanta, supra,* 180 F.3d at 538("Vague and general statements of optimism constitute no more than 'puffery' and are understood by reasonable investors as such.").

developments affecting Wessex, Wessex's capital costs, and timing and success of future acquisitions.[317]

In June 1999 Azurix went public[318] with Enron retaining 34% of its stock.[319] Consequently, public disclosures by Azurix are also relevant and should be considered by the Court[320] in evaluating Plaintiffs' complaints about Azurix. Significantly but understandably, Plaintiffs fail to mention anywhere in the Complaint the March 20, 2002, Memorandum and Order ("*Azurix* Order") involving the Azurix IPO, dismissing with prejudice a purported class action alleging claims under §§ 11, 12(a)(2), and 15 of the Securities Act, and §§10(b) and 20(a) of the Exchange Act. *In re Azurix Corp. Securities Litigation*, Master File No. H-00-3493, Southern District of Texas, Houston Division (Hon. Sim Lake). In *Azurix*, the plaintiffs raised a very similar set of claims asserting Azurix had "touted" its ability to take advantage of the privatization trend. The *Azurix* plaintiffs also alleged defendants had misrepresented the privatization strategy, financial condition, and future prospects for the new company, and failed to disclose water quality problems in the Buenos Aires facility.[321] In dismissing the *Azurix* plaintiffs' complaint, Judge Lake repeatedly recognized that broad statements of corporate

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[317] App. Tab 2, at 4.

[318] *See* SEC Tab 50.

[319] *See* SEC Tab 10, at 88.

[320] A district "court may take judicial notice of related proceedings and records in cases before the same court." *MacMillan Bloedel Ltd. v. Flintkote Co.*, 760 F.2d 580, 587 (5th Cir. 1984).

[321] *See, e.g.*, Consolidated and Amended Class Action Complaint, *In re Azurix Corp. Sec. Lit.*, Master File No. H-00-3493, U. S. District Court for the Southern District of Texas, Houston Division, ¶¶ 1, 2, 4, 5.

optimism are not actionable because they are not material. *E.g., Azurix* Order at 32, 40, 43, 44, 45, 46, 47. Judge Lake further recognized that Plaintiffs impermissibly relied on events occurring long after the statements were made to establish their falsity. *Azurix* Order at 30-31, 33, 35-36. The *Newby* Plaintiffs' allegations involve the same "broad statements of corporate optimism" and "fraud by hindsight" Judge Lake has already rejected.[322]

Forward-looking statements and risk factors were carefully identified and disclosed in public filings in connection with Azurix Corp.'s IPO in June 1999, as Judge Lake repeatedly noted in the *Azurix* Order[323].

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[322] *Id.* at ¶19, *In re Azurix Corp. Sec. Lit.*, Master File No. H-00-3493.

[323] The Azurix Prospectus warned the public of numerous risks facing the new venture, including:

i) Azurix's "limited operating history and the unpredictable results of our acquisition strategy make it difficult to forecast our future operating results. We expect to experience significant competition...."

ii) the risk that "we may not be able to successfully complete acquisitions of water and wastewater assets and develop projects...." – which happened, particularly in Argentina;

iii) the risk of"price regulation that could adversely affect our financial results" – which is exactly what happened in England after the Wessex rate review. Indeed, the Azurix Prospectus warned that "the current U.K. rate review" of Wessex's rates "*is likely to reduce significantly Wessex's revenues and earnings*" – -which is what subsequently happened on November 25, 1999, when the U.K. announced a 12% price cut effective April 2000;

iv) the risk that "failure to accurately identify and assess ... risks ... could adversely affect our operating results" – such as the refusal of the Buenos Aires provincial government to meet its contractual obligations, including transferring certain assets, completing work projects, and paying certain costs;

v) the risk of "water supply contamination" – such as the algal bloom which occurred in the Buenos Aires reservoirs in 2000.

The Azurix Prospectus also identified numerous other risks which could adversely affect its operating results, including potential difficulty in financing operations, lack of operational control in certain projects, potential difficulty in managing growth, environmental factors and changes in regulations, political and economic changes, work stoppages and labor problems, currency fluctuation, operating in countries without adequate revenue collection systems (such as Azurix encountered when it took over the Buenos Aires concession on July 1, 1999 and was not provided complete billing and customer records[324]), and restrictions in its debt agreements.[325]

These warnings foreshadowed what occurred in the ensuing year. Azurix, like Enron, publicly disclosed the very problems Plaintiffs now complain were concealed:

> Participants in the global water market face significant challenges, including qualifying for the bidding process, obtaining and demonstrating operating experience and management depth, accessing capital, obtaining and demonstrating expertise in managing international infrastructure projects, identifying and evaluating transactions and assessing and mitigating risks, especially operational, political and regulatory risks. As a result, only a small number of companies currently compete globally in the water and wastewater privatization market. *We face significant competition from companies larger than we are, companies with longer operating histories and greater experience in securing water and wastewater projects than we have and other new entrants to the global water industry.*[326]

Azurix again publicly disclosed numerous factors that could affect its future results and the accuracy of its forward-looking statements, including, for example, its short operating history; price, competition and regulations that could reduce operating revenue; significant competition;

[324]SEC App. Tab 89, at 12.

[325]Similar warnings of risk and risk factors were disclosed in the Azurix 1999 10-K, SEC App. Tab 90, at 35-41.

[326]SEC App. Tab 90, at 16.

liability for water supply contamination; and operating in countries without adequate revenue collection systems.[327]

Thus Azurix's public filings in its Prospectus and 1999 10-K continued to provide much more detailed warnings than have previously been held to satisfy the bespeaks-caution language, and the warnings in each year *fit what in fact occurred in the ensuing year.* There simply were no material misrepresentations or omissions concerning Azurix.

D. NEWBY'S CLAIM THAT ENRON SHOULD HAVE WRITTEN DOWN AZURIX ASSETS SOONER IS NON-ACTIONABLE.

As they did with Dabhol, the *Newby* Plaintiffs complain of the timing of Enron's write-down of the Azurix assets after Enron took Azurix private in March 2001 for $327.5 million:[328] Again, as they did concerning Dabhol, Plaintiffs fail to satisfy the pleading requirements of Rule 9(b). Differences of opinion regarding the timing of write-downs do not state a claim of fraud.

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[327]SEC App. Tab 90, at 35-38.

[328] "591. It was clear by 00 that Azurix had overpaid for a $489 million franchise to supply water services in Buenos Aires, Argentina. The Argentina investment was troubled from the beginning as promised new infrastructure was not provided by the government. In 11/00, Azurix had been fined in Argentina for negligence which left customers without water for five days. In 00, Mark-Jusbasche left the Company in part due to disappointing financial results at Azurix. In the 4thQ 00, Enron had to record an after-tax charge of $326 million to reflect Enron's portion of impairments recorded by Azurix. In late 00, Enron had announced plans to take Azurix private - which it did in 3/01 for $327.5 million. This amount was booked as an asset, but due to the problems with Azurix's business, defendants knew it was impaired from the time of acquisition, if not before. Yet Enron failed to record a charge.

592.The situation did not improve during 01. Enron was planning extensive layoffs at Azurix, as the business was not at all successful. However, in order to overstate earnings, in early 01, Enron failed to take any charges for the impairment until the 3rdQ 01, when it recorded a charge of $287 million."[328]
See NCC at ¶¶ 591-592

DiLeo, 901 F.2d at 267.[329] Plaintiffs also fail to identify, the "specific time, place, and contents of the false representations, along with the identity of the person making the false representations and what the person obtained thereby." *Schiller v. Physicians Resource Group, Inc.,* 2002 WL 318441, *4 (N.D. Tex. Feb. 26, 2002)(citing *Melder*, 27 F.3d at 1100) and *Shushany*, 992 F.2d at 521. No false representation is identified. No individual is identified. The general allegation that "defendants knew [Azurix] was impaired" fails to state a claim under the PSLRA, as does the accusation in Paragraph 592 that Enron failed to take a charge until October 2001 "in order to overstate earnings." *Id.* at *6 Plaintiffs do not allege, at all, any defendant had knowledge (or, more accurately, had reached an internal conclusion) that GAAP dictated a material write-down of Azurix's assets, much less to any particular value. *In re Glenfed, Inc. Sec. Litig.*, 11 F.3d at 849 (claim that loan reserves should have been increased earlier "does not speak to fraud," citing *DiLeo*). Even if Enron considered a write-down prior to the October 2001 announcement to some particular value, "internal projections still in the process of consideration and revision cannot serve as the basis for [10-b5] liability." *Kreindler*, 877 F.Supp. at 1153 (quoting *Arazie*, 2 F.3d at 1468).

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[329] *Grassi v. Information Resources, Inc.*, 63 F.3d 596, 600 (7th Cir. 1995) ("Plaintiffs essentially claim that [defendant] should have written off its bad investment sooner – but this is not fraud."); *Kriendler v. Chemical Waste Management, Inc.*, 877 F.Supp. 1140, 1153 (N.D.Ill. 1995) (dismissing as claims related to the timing of a write-down; "The Seventh Circuit has rejected the notion that the timing of an accounting write-down can serve as a basis for fraud: No matter when a bank [writes down a loan], someone may say that it should have acted sooner. If all that is involved is a dispute about the timing of the write-off, based on estimates of the probability that a particular debtor will pay, we do not have fraud; we may not even have negligence." *K-Tel*, 107 F.Supp.2d at 1000 ("Plaintiffs conclusory allegation that an impairment loss existed and that [defendant] was motivated to hide the losses suffered by the Subsidiary is insufficient.").

In sum, the *Newby* Plaintiffs' allegations centering on Enron's water business are impermissible group pleading, completely fail to allege fraud with requisite particularity, and must be dismissed.

4. THE NEWBY PLAINTIFFS' CONCLUSORY ONE-SENTENCE ALLEGATIONS REGARDING ENRON'S PROJECTS IN OTHER EMERGING NATIONS MUST BE DISMISSED.

Plaintiffs make conclusory allegations that Enron also had financial problems in other projects in emerging nations. *See e.g.* NCC at ¶ 581; TCC at ¶¶ 202, 209. These allegations not only are facially noncompliant with the PSLRA, they fail to comply with *any* acceptable pleading standard. They should be dismissed.

BATANGAS, PHILIPPINES. Enron built a power plant project in Batangas, Philippines which began operating in 1993, several years prior to the alleged class period. The project was *already built and disclosed* before the alleged class period, as reflected on the face of Enron's public filings.[330] The *entirety* of Plaintiffs' allegations concerning the Batangas project consists of the following:

> Other Enron international operations were financial disasters and were not 'high return projects' that 'would lead to major earnings gains for years.' ... Likewise, at Batangas in the Philippines, developers promised – and were paid for – a water-cooled power plant on flat ground, but engineers faced the all but impossible task of building the plant on the side of a hill, using one road, and no access to water.[331]

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[330] *See, e.g.*, SEC App.Tab 1, at 14 ("EPP currently has interests in two power plants in the Philippines. The Batangas power project is an approximately 110-megawatt fuel-oil-fired diesel engine plant located at Pinamucan, Batangas, on Luzon Island, which began commercial operation in July 1993. ... Both projects were developed by Enron, are 50% owned by EPP and sell power to the National Power Corporation of the Philippines.").

[331] NCC at ¶ 155(i).

No other reference is made to this project anywhere in the 500-page Complaint. To the extent this allegation is decipherable at all, it appears to make allegations only against unnamed Philippine "developers." It does not even *mention* any individual Defendant, let alone describe any knowledge or involvement they had in the Batangas project. *See, e.g.*, *BMC*, 183 F.Supp.2d at 876 n.24 ("There is no indication as to when such purported improper conduct occurred, ... the monetary value of affected transactions, ... the identities of customers or salespersons involved, or when and if any of the individual Defendants authorized or knew of the alleged agreements."). The allegation is frivolous under PSLRA standards, and should be dismissed.

SOUTH AFRICA, AND CHINA. Plaintiffs also argue that "[c]osts for South African projects involving oil and gas reserves, pipelines, and a plant designed to convert ore into another form of energy" were snowballing "quickly."[332] Even more cryptically, Plaintiffs add that "projects in China" snowballed quickly. No other reference is made to the unspecified Chinese and South African projects, anywhere in the Complaint.

The fact that Enron fully disclosed its deferred expenses for this and other projects, and the appropriateness of Enron's handling of deferred expenses, is addressed in Part V.D.2. of this Motion.

This pleading again fails to mention any Defendant, let alone plead the who-what-when-where-how facts required to show individual liability under Rule 9(b) and the PSLRA. The reference to "projects in China" fails even to minimally provide notice about what, if any, transactions, cities, dollars, or even *years*, are supposedly being referenced, let alone any alleged

[332]NCC at ¶ 121(f). The Newby Plaintiffs repeat the same allegation, verbatim, at ¶ 155(k), and in almost verbatim form at ¶ 581.

false information concerning it. In *Tuchman*, *supra*, the Fifth Circuit stated that Rule 9(b) requires the plaintiff to allege "'the particulars of "time, place, and contents of the false representations, as well as the identify of the person making the misrepresentation and what [that person] obtained thereby."'" 14 F.3d at 1068. The Complaint is devoid of such "particulars," and even of the minimal notice pleading that is required outside the PSLRA. Those allegations must be dismissed. 183 F.Supp.2d at 876 n. 24; *Greebel,* 194 F.3d at 202-04.

While it is impossible to tell from the *Newby* Plaintiffs' pleading what specific misdeeds it is alleging occurred on the "projects in China" or South African interests, the public filings again show that Enron disclosed any setbacks which affected its projects. In the September 3, 1997 S-3 Registration Statement, for example, Enron disclosed:

> ***Unanticipated delays have been experienced in the development and construction*** of several of the projects designated by Enron at the time of EPP's formation (or by later amendment of the Purchase Right Agreement) for eventual transfer to EPP (the 'Designated Development Projects'), ***notably*** the planned power plant, fuel facilities and related ancillary facilities in Dabhol, India and ***the planned power plants in Hainan Province and People's Republic of China.*** Furthermore, the oversight process established by the Purchase Right Agreement has proven to be more expensive and complex than was contemplated when EPP was formed.[333]

Enron elaborated on the delays in China in subsequent disclosures, which were also publicly known in 1997 before the alleged class period:

> The Hainan Island power project was anticipated to be offered to EPP in 1995, but due to ***a contractual renegotiation forced by the Chinese power authority***, the ***project was not offered*** in 1995 and, because the final renegotiated contracts ***have still not been executed***, the project is not in a position to be offered to EPP.[334]

[333]SEC App. Tab 95, at 26-27. Enron also made this disclosure in its Oct. 10, 1997 S-4/A Registration Statement, at 23; Oct. 16, 1997 S-4/A Registration Statement, at 24.

[334]SEC App. Tabs 69, at 23; 70, at 24.

Plaintiffs make no reference to any specific delay, setback, or other allegedly noteworthy event that in any way affected the South African interests that it contends was not disclosed.

Enron also disclosed that all of its projects in emerging nations, including China, were inherently risky, and provided specific cautionary language. First, Enron disclosed to the public in its 1997 Form 10-K, and thereafter, that its Chinese project was in effect in an untried market — the first such U.S. project in that nation:

> Enron has a 50% interest in a 152-megawatt diesel combined-cycle power plant on Hainan Island, an economic free trade zone off the southeastern coast of China. The independent power project is the <u>first such project developed by a U.S. company in China</u>. An Enron affiliate is operator and fuel manager.[335]

In the same section where Enron identified its Chinese project, it also gave the same bespeaks-caution warnings it provided for the Dabhol and other emerging nation projects, that there are risks of political instability, changes in laws/policies, and "<u>**no assurances** that these projects will commence commercial operations</u>." [336] Even if Plaintiffs were to have supplied any particularized allegations of alleged misstatements or omissions — and they do not — "no reasonable investor could have been misled" that these foreign ventures were "anything but a risky venture." *Parnes, supra*, 122 F.3d at 548 (finding "no assurance" language to constitute an "explicit cautionary statement").

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[335]SEC App. Tab 2, at 19; 6, at 20; 10, at 16.

[336]SEC App. Tab 1, at 15-16, 92.

DOMINICAN REPUBLIC. Enron disclosed that it owned an interest in a Dominican Republic power plant, which began operations prior to the alleged class period.[337] Plaintiffs, however, plead:

> For instance, Enron's Dominican Republic power plant project was a disaster before ground was broken. Enron paid to build a power plant in a country where existing plants were not being paid for. Enron went ahead, because internal developers got the majority of their bonuses before construction ever began.[338]

Once again, *no other reference* is made to this project anywhere in the 500-page Complaint. The argument that Enron built a plant in "a country where existing plants were not being paid for" does not describe *any* cause of action, let alone for securities fraud. The *Newby* Plaintiffs make no reference to what, if any, other Dominican Republic plant it is referring to,[339] the identity of the buyers and/or investors for those plants, or whether those were the same persons or entities who allegedly participated in either building or investing Enron's plant in the Dominican Republic. They do not even allege that any events transpired during the alleged class period.

More importantly, however, Plaintiffs again make no reference to any individual Defendant, and no effort to show any connection whatsoever between any such Defendant and Enron's plant in the Dominican Republic. These allegations "fail to satisfy any pleading standard, let alone the heightened standard set forth in Rule 9(b)." *See Polar Int'l Brokerage Corp. v.*

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[337]*See, e.g.*, SEC App.Tab 2, at 18 ("Enron has a 50% interest in a 185-megawatt barge-mounted combined-cycle power plant at Puerto Plata on the north coast of the Dominican Republic. The plant began operation in January 1996. Power is sold pursuant to a 19-year power purchase agreement with the Dominican Republic government utility.").

[338]NCC at ¶ 155(i).

[339]For instance, Enron acquired an interest in another Dominican Republic facility, as disclosed at SEC App. Tab 10, at 15).

Reeve, 2000 WL 827667, at *13, Fed. Sec. L. Rep. (CCH) ¶ 91,005 (S.D.N.Y. June 27, 2000) ("vague and bare references to 'internal projections'" without identifying who created them or specifics on what they stated fail to satisfy even non-PSLRA pleading standards). Those allegations must be dismissed under the PSLRA.

To the extent that any delays occurred in commencement of operations on its Dominican Republic, Enron disclosed them to the public — and did so even before the alleged class period commenced. Plaintiffs make no allegation to the contrary, let alone with the particularity required under the PSLRA. For example, in both its October 10, 1997 and October 16, 1997 Form S-4/A, Enron disclosed:

> In addition, of the two projects which have been offered to EPP, only the Centragas pipeline project in Colombia was offered at the time originally anticipated. The other project, the Smith/Enron power project at Puerto Plata, Dominican Republic was scheduled to reach commercial operations and be offered to EPP in 1995. This date was delayed until 1996 due to delays in the project reaching commercial operations, as required by the Purchase Right Agreement.[340]

Enron disclosed when that delivery occurred, which also was completed prior to the alleged class period.[341] It is impossible to detect what is alleged by the *Newby* Plaintiffs to be fraudulent. Their unintelligible complaint should be dismissed.

VI. THERE WAS NO FRAUD ON THE MARKET BECAUSE THE FACTS PLAINTIFFS CLAIM WERE CONCEALED WERE FULLY DISCLOSED TO OUTSIDE ANALYSTS.

Plaintiffs' claim Enron "hid" its debt and its risks from potential investors. *See* NCC at ¶¶ 44-48, 70, 393, 418, 506; TCC at ¶¶ 2, 316, 368, 395. This allegation is belied by the analyst

[340]*See* SEC App. Tab 69 at 29; 70, at 24-25.

[341]*See, e.g.*, SEC App. Tab 1, at 14; SEC App. Tab 91.

reports and press releases on which Plaintiffs rely to support their claim that "the market" was deceived.[342]

A. THE ANALYST REPORTS

Analysts both noted and warned investors that Enron, unlike more traditional gas and pipeline corporations, was more of a financier and investment bank than a nuts-and-bolts rig operator. As such, analysts consistently emphasized that market risks to Enron exceeded those normally associated with the traditional energy industry. Although Defendants do not adopt the information contained in analysts' reports, in consideration of the quality of a company's disclosures, courts have given considerable weight to the fact that a third party, such as an analyst, understood the disclosures and re-issued the information to the markets. For example, reports from Deutsche Bank, dated January 13, 1999 and September 15, 2000, (*see* NCC at ¶ 796) relied on by Plaintiffs, disclosed that:

> Because of its businesses, including that of price risk management services, Enron could be exposed to more market risk than the average energy company. Enron manages market risk on a portfolio basis, subject to parameters established by its Board of Directors, and an independent risk control group ensures compliance with stated risk management policies. With its use of financial instruments, the company could be exposed to market and credit risks resulting from adverse changes in commodity and equity prices, interest rates and foreign exchange rates.[343]

[342]Since Plaintiffs claim to have relied on these reports (see NCC at ¶¶642-799, 983(d), it is appropriate for the Court to consider their entire contents in support of Defendants' Motion to Dismiss. F.R.C.P. 56; *See Bovee v. Coopers & Lybrand C.P.A.*, 272 F.3d 356 (6th Cir. 2001).

[343]App Tab 16, at 1 (cited by Plaintiffs at NCC at ¶127); App. Tab 30, at 18 (cited by Plaintiffs at NCC at ¶257).

Additionally, a September 15, 2000 Deutsche Bank report (*see* NCC at ¶ 796) made additional, explicit warnings regarding the risks associated with Enron's financing activities under bolded headings:

> Investment Positives and Negatives
>
> * * *
>
> Negatives:
>
> Price risk management services could expose ENE to more market risk than the average energy company.
>
> With its use of financial instruments, ENE could be exposed to market and credit risks resulting from adverse changes in commodity and equity prices.[344]

Similarly a J.P. Morgan dated June 9, 1999, near the inception of Plaintiffs' "class period,"[345] stated that Enron maintained *nearly half* of its assets off balance sheet. NCC at ¶153; TCC at ¶¶ 605, 214. "Enron is in the proverbial 'sweet spot' of its engineered virtuous circle. Its $30 billion market cap and $29 billion in assets *(plus $22 billion off the balance sheet)* stretch from Argentina to Zhaoyin, China..." *See* App Tab 21, at 1. J.P. Morgan extolled the virtues of Enron's off-balance-sheet financing strategy, asserting that Enron's "scale adds capabilities, *financing options* and risk tolerance." *Id.* at 3. J.P. Morgan went on to observe that, "Although cash from operations should exceed $2 billion per year, Enron's appetite for expansion and pipeline of projects *won't allow those funds to sit on the balance sheet.*" *Id.* at 7.

That J.P. Morgan understood the facts Plaintiffs claim were concealed is evident:

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[344]App. Tab 30, at 2 (emphasis in original) (cited by Plaintiffs at NCC at ¶257).

[345]The *Newby* Plaintiffs assert a class period from October 19, 1998 to November 11, 2001; the *Tittle* Plaintiffs assert a class period from January 20, 1998 to December 2, 2001.

Financial Engineering Accelerates Earnings

[Enron Capital & Trade] has significant flexibility in structuring contracts *and hence booking earnings*. It is primarily a financial business and hence uses "mark to market" accounting. *As such, contracts can be structured to recognize the economic value of projects long before they are operational and cash is coming in the door.* For example, Sutton Bridge, a power plant that will start operations in the second quarter of 1999, hit ENE's bottom line in 1997. Its output is the backstop for a swap agreement, the present value of which has already been marked to market and booked by ECT. *This has two effects: front-end-loaded earnings that bias the denominator in the P/E ratio and a timing disconnect between projects' cash and earnings effects.*

* * *

The Biggest Brokerage Firm in Texas

Enron structures financial products and uses "mark to market" accounting. This limits the comparability of financial statements, as a project's bottom-line effect is bound only by ECT's financial engineering skills.

* * *

Assets from Price Risk Management Offer a Financing Vehicle

As Enron accumulates risk, it sells that risk off to various counterparties. Securitization of this risk is another source of funds to Enron. Enron monetized "certain of its portfolio of energy contracts and merchant investments, [resulting] in proceeds to Enron in excess of $1.5 billion." "Equity" in Price Risk Management Will Continue to Be Monetized.

NOL Carryforwards Lower Enron's Tax Bite

Enron has a low tax rate thanks to $1.4 billion in net operating loss carryforwards ...Also, equity in earnings of international subsidiaries are not subject to U.S. tax. They are predominantly noncash since Enron is reinvesting its earnings from those projects locally, and they are in tax advantaged structures. For example, the Dabhol, India project ownership is through a Cayman Islands shell corporation that pays minimal taxes in the United States.

App. Tab 21 at 4, 6, 20-21.[346] At the inception of the class period, J.P. Morgan informed the market of Enron's extensive use of off-balance sheet financing, derivatives, securitizations and monetizations—and did so in the context of recommending that investors buy Enron stock. Plaintiffs cannot fairly contend that the market was deceived in the face of a prominent analyst's observation that "Financial Engineering Accelerates Earnings...a project's bottom line effect is limited only by [Enron's] financial engineering skills." *Id.*

Other analyst reports incorporated in Plaintiffs' complaint confirm that the market as a whole knew the facts that J.P. Morgan highlighted in its June 1999 Buy Recommendation. The market knew the extent of Enron's off-balance sheet financing. It was well aware of Enron's exposure to credit risks as a result of its derivative trading. Finally, the market understood that the notes to Enron's financial statements were a source of important information about the company's financial health. Excerpts from the reports, relied on by Plaintiffs, that establish this "truth on the market" are set out below:

B.T. Alex Brown – January 13, 1999

> The net capital expenditures made by Enron for the year 1998 will approximate \$2.5 billion. Effectively, the company will have spent substantially more which is being financed through 'non-recourse financing' and other off-the-balance-sheet financing. The major components of the net expenditures are as follows: Exploration and Production \$800 million; Transmission and Distribution \$350 million; Water \$800 million; Wholesale Energy Marketing \$500 million. Source: Company data. *See* App. Tab 16, at 7-8.

Deutsche Banc Alex. Brown – September 15, 2000[347]

[346] J.P. Morgan also observed that for the years 1999 to 2001, Enron reflected as "long term debt" more than \$1 billion of "company-obligated preferred securities of subsidiaries." *Id.* at 37.

[347] *See* App. Tab 34, at 2 ("ENE has shifted its business portfolio towards trading and marketing of commodities – a business with more risk than regulated gas transmission and electric distribution."); App. Tab 46, at 2. ("The Assets & Investments portion of EBIT was \$305

With its use of financial instruments, ENE could be exposed to market and credit risks resulting from adverse changes in commodity and equity prices....Because of its businesses, including that of price risk management services, Enron could be exposed to more market risk than the average energy company. Enron manages market risk on a portfolio basis, subject to parameters established by its board of directors, and an independent risk control group ensures compliance with stated risk management policies. App. Tab 30, at. 2.

Lehman Brothers – July 26, 2001

In an effort to improve returns and free up capital for more lucrative re-deployment in expansion of the wholesale franchise, Enron has targeted a significant reduction in their merchant investment portfolio and the assets that were accumulated in the push into the global energy infrastructure business....Successful sale and redeployment...is the key to sustaining a higher multiple as it will provide investor comfort in the sustainability of Enron's `asset light' or more service oriented business model. It would also reduce the number and profile of some of the more confusing notes in ENE's reported financials. .... While it's hard to handicap the timing the actuality provides nothing but upside given the decline in valuation to a market multiple. App.Tab at 34 at 2

J.P. Morgan – August 17, 2001

related party transactions have ended, eliminating a significant source of consternation....Another issue that has been cleared up is Andy Fastow's (CFO) participating in a fund (LJM) as a general partner, that would routinely transaction with Enron. That relationship has ended and Mr. Fastow has severed his ties to Enron. App. Tab 35 at 1.

Bank of America Securities – October 16, 2001

The company also provided slightly more detail in several areas of operations. This should partially remove a long-standing overhang on the company, which has always had complex reporting structures, and provide needed clarity to its earnings model. App. Tab 36 at 1.

CIBC World Markets – October 17, 2001

Not unexpected, during the current quarter Enron took non-recurring charges of $1.01 billion related to write-off for Enron's investment in Azurix, Broadband

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million versus $240 million a year ago with the increase related to asset sales, income from asset operations, and mark-to-market investment gains.").

> and other investments....$544 million related to losses associated with certain investments, principally Enron's interest in The New Power Company, broadband and technology investments, and early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity. App. Tab 37, at 1, 3.

B. THE PRESS RELEASE REPORTS

1. EXCERPTS FROM MEDIA REPORTS INCORPORATED IN PLAINTIFFS' COMPLAINT CONFIRM THAT THE "HIDDEN" FACTS ABOUT ENRON WERE FULLY DISCLOSED TO THE MARKET

Plaintiffs have also incorporated in their Complaints more than sixty news articles that they contend support their claim that the market was defrauded. Sometimes, these articles are actually identified; on other occasions, Plaintiffs quote from the articles but fail to identify them.[348] When considered in context, however, the articles on which Plaintiffs rely establish that neither the market, nor any potential investor, was misled concerning Enron's financial condition. Relevant excerpts from these articles, categorized by topic, appear below:

a. MANY ARTICLES NOTED ENRON'S EXTENSIVE USE OF OFF-BALANCE SHEET AND OTHER "GROUND BREAKING" AND "INNOVATIVE" FINANCING TECHNIQUES

Plaintiffs assert repeatedly that Enron used off-balance sheet financing to "hide" its debt and to "conceal" losses. *See e.g.,* NCC at ¶¶ 4, 44, 70, 98, 506, 668; TCC at ¶¶ 2, 5, 155, 312, 316. The press reports Plaintiffs' rely on establish that, not only were these debts not "hidden," Enron's use of off-balance sheet debt was regularly lauded by the financial press for its innovation and creativity. In other articles, however, the financial press treated the same techniques as "red flags" or used them to question "How Does Enron Make Money?"

[348] Because Plaintiffs rely upon these documents in their Complaints, the court may consider them in their entirety to place in context the facts Plaintiffs allege were concealed. *See In re BMC*, 183 F. Supp. 2d at 881-84.

Regardless of the viewpoint of the authors, these articles establish that the facts Plaintiffs claim were concealed were actively discussed in the market for Enron securities—from near the beginning of Plaintiffs' purported class period to its end.

CFO Magazine – June 1999[349]

> This article, entitled "Balancing Act Will a new accounting rule aimed at off-balance sheet financing trip up Enron?," contains a detailed exploration of why Enron resorted to off-balance sheet debt and the ways in which Enron employed it. "Conventional financing techniques to exploit the industry's current and potential size would jeopardize the BBB+ credit rating Enron earns from such agencies as Fitch...and Standard & Poors, raising the company's cost of capital. That reflects the fact that Enron's investments take considerable time to produce significant income. As a result, ...most conventional cash-flow and interest-coverage ratios are currently weak for Enron's rating." The article goes on to quote Enron's Chief Financial Officer, Andrew Fastow, as acknowledging that "[o]ur industry is characterized by high capital investments, with low initial cash flow and earnings coming off those investments....so you can't just issue equity and dilute shareholders in the near term.....My credit rating is strategically critical." App. Tab 9, at 1.
>
> Having made this observation, the article then asserts that "The financial balancing act this situation requires has turned Enron into a master of creative financing." A new FASB proposal, the article noted, "would seem to drastically increase Enron's consolidated debt level from roughly 40 percent of total capital to more than 70 percent. The reason: Enron does not consolidate a number of highly leveraged subsidiaries in which it owns—or plans to own—no more than 50 percent of the voting stock." App. Tab 9, at 1-2. The article went on to review two major transactions that Enron had accomplished by keeping significant amounts of debt off of its balance sheet: Azurix ($1 billion), Cogen New Jersey ($1 billion). *Id.* In Mr. Fastow's words, "you've got very significant leverage here, much higher leverage on these facilities than you have at Enron." *Id.* at 3.
>
> Finally, the article makes clear that investors and analysts understood the import of Enron's off-balance sheet financing techniques. A Duff & Phelps analyst quoted in this article noted that analyzing Enron's creditworthiness required him to "look through the accounting." The article recounts that S & P's analyst "adds back into Enron's debt anywhere from 10 percent to 15 percent of its loan

[349] *See* App. at Tab 9, *passim* cited at NCC at ¶19.

guarantees, 10 percent to 20 percent or more of its nonrecourse debt, and the present value of its operating leases and syndications." App. Tab 9 at 4.

The article also noted that these approaches were "a far cry from the additional $10 billion in long-term debt and other liabilities that would be found on Enron's balance sheet if the company were deemed to control all of its unconsolidated subsidiaries." *Id.*

CFO Magazine – October 1999[350]

In another feature article, three months later, CFO Magazine reported the widespread accolades accorded to Enron's chief financial officer for his use of off-balance sheet financing structures. Quoting Lehman Brothers analyst, Ted Izatt, the article said "Thanks to Andy Fastow, Enron has been able to develop all these different business which require huge amounts of capital, *without diluting its stock price or deteriorating its credit quality—both of which actually have gone up. He has invested a groundbreaking strategy.*" App. Tab 2, at 1.[351]

So innovative was this approach to financing that it earned Mr. Fastow "the 1999 CFO Excellence Award for Capital Structure Management." *Id.* The article went on to recount how Enron transformed its finance department "into a merchant finance organization, one engaged in the intermediation of both commodity and capital risk positions, ...[e]ssentially, we would buy and sell risk positions." The magazine next characterized Enron's approach to its financing activities as "*Walking the Tightrope.*" *Id.* at 2.

Fortune Magazine – March 5, 2001[352]

At very near the high of Enron's stock price, this article from Fortune magazine asked the question "*Is Enron Overpriced*?" The author's conclusion was that, although Enron was the darling of analysts, "the company remains largely impenetrable to outsiders." App. Tab 4 at 1. The article noted that "to skeptics, the lack of clarity [concerning Enron's financial presentations] raises a red flag about Enron's pricey stock." *Id.* The author quoted a J.P. Morgan analyst, Chris Wolfe, as saying Enron was "*an earnings-at-risk story.*" *Id.* The article then reviewed, in detail, the perceived risks of Enron's merchant investment activity,

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[350] *See* App. Tab 2, at 1-4 cited at NCC at ¶ 175.

[351] At this point, the article explicitly refers to the reader to the June CFO Magazine article, "Balancing Act".

[352] App. Tab 4, cited in NCC at ¶ 550.

its wholesale trading business and its investment in broadband. Importantly for this case, the article noted what had already been disclosed by Enron and reported by other analysts:

> Accounting standards mandate that [Enron's] assets and liabilities from its wholesale business be `marked to market'—valued at their market price at a given moment in time. Changes in the valuation are reported in earnings. But these earnings aren't necessarily cash at the instant they're recorded.

Fortune Magazine – December 24, 2001[353]

> [I]t's not hard to find the person who first said that the emperor had no clothes. *In early 2001*, Jim Chanos, who runs Kynikos Associates, a highly regarded firm that specializes in short-selling, *said publicly what now seems obvious: No one could explain how Enron actually made money.* Chanos also pointed out that while Enron's business seemed to resemble nothing so much as a hedge fund--a giant hedge fund sitting on top of a pipelineit simply didn't make very much money.

b. THE FINANCIAL PRESS WAS WELL AWARE OF LOSSES AND DIFFICULTIES AT ENRON'S BUSINESS UNITS.

Plaintiffs also suggest that Enron also concealed from the market business difficulties at its retail energy, international, broadband and wholesale units. NCC at ¶ 37-39, 121; TCC at ¶ 204-39. This claim is likewise belied by the media reports cited by Plaintiffs.

i. Enron Energy Services

Houston Chronicle – July 14, 1999[354]

> In an article concerning Enron's quarterly earnings release, the Houston Chronicle reported that "Enron's retail energy services unit [EES] continued to lose money in the second quarter as it has since its inception in the first quarter of 1997. The unit had an operating loss of $26 million in the second quarter, compared with an operating loss of $43 million in the second quarter of 1998. Such losses come as no surprise to the market, which has been warned repeatedly to expect them this year. App. Tab 1, at 2-3.

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353 App. Tab 8, at 4 cited in NCC at ¶ 51.

354 *See* App. at Tab 1, pg. 1-2.

ii. International Operations

Dow Jones Energy News Service – January 9, 2001[355]

> The MSEB [Maharashta State Electricity Board] *has yet to pay Dabhol Power's electricity bills for October and November 2000*....Speculation in the media has been rife as to whether lenders may stop disbursing funds for Phase 2 of the Dabhol power project, given the dispute surrounding Phase 1 between the MSEB and DPC [Dabhol Power Company]. App. Tab 3 at 1-2 (emphasis added).

Bloomberg News Archive –July 12, 2001[356]

> Writing concerning the payment at Dabhol, this report notes that Dabhol Power "and its customer, the Maharashtra State Electricity Board, are in the midst of a seven-month-old dispute over ($64 million) in the board's unpaid bills from December and January and over the price Dabhol charges for power. In May, Enron gave preliminary notice that it was planning to terminate its contract with the board in six months unless the bills were paid. Days later, the board said it was canceling the contract and stopped buying power from Dabhol....any potential buyers for Dabhol would likely have a "jaundiced"view of the project, given the difficulties Enron has had." App. Tab 5, at 1.

iii. Broadband

CNNFN The Money Gang – July 12, 2001[357]

> The broadband business has proven to be one of the weak spots for the company right now....There was a bigger loss at Enron broadband services than we had been forecasting...*The company has said publicly, including today, that it intends to make several aggressive moves over the next several months to minimize further risks and losses in that broadband services business*....[T]he content services business of Enron broadband services ...is really the source of the problem.

App. Tab 6 at 1, 2, 3.

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[355] App. Tab 3, at1 cited in NCC at ¶ 279.

[356] App. at Tab 5 cited in NCC at ¶ 330.

[357] App. Tab 6, cited in NCC at ¶ 332.

Bloomberg News Archive – July 25, 2001[358]

> Analysts have also cited concern about unpaid power bills by Enron customers in California and India, *and losses by Enron's broadband trading unit, which may hurt Enron's profits*....Enron will cut its losses *while it waits out a `meltdown' in broadband communications*. App. Tab 7, at 1.

iv. Wholesale

Bloomberg News Archive – July 25, 2001[359]

> California is negotiating refunds with energy traders and generators after power prices soared in the state, leaving its two largest utilities so far in debt they could no longer buy electricity for their customers. The state has threatened to sue if power sellers don't agree to $8.9 billion in refunds. App Tab 7, at 1.

C. CONCLUSION

These candid, contemporaneous discussions of the very facts Plaintiffs contend were concealed are of enormous significance to the question whether Plaintiffs have adequately stated a "fraud on the market" claim. "The Court may also consider documents 'integral to and explicitly relied on in the complaint,' that the defendant appends to his motion to dismiss, as well as the full text of documents that are partially quoted or referred to in the complaint." *In re BMC*, 183 F. Supp. 2d at 882. By relying extensively on analyst reports that establish that the facts Plaintiffs claim were concealed were, in fact, disclosed, Plaintiffs have incorporated, in their own complaint, the documents that establish that there were <u>no material misrepresentations or omissions</u> by Enron (or by <u>any</u> defendant) concerning Enron securities.

In sum, a fair reading of the real-time analyst and media reports establishes that the very facts plaintiffs contend were concealed from them were, in fact, well-known to the market, were

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[358]App. Tab 7 cited in NCC at ¶ 337.

[359]App. Tab 7 cited in NCC at ¶ 337.

fully disclosed and were actively debated among market participants. There was, in fact, no fraud on the market as it pertained to Enron—people simply perceived, and responded differently to, the disclosed facts concerning its operations. Differences of opinion make a market—they do not make a fraud.

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